In the United States this past year, growing movements for social, racial and environmental justice, and the impact of an unprecedented health crisis, have coincided with a range of institutions increasing their focus on promoting environmental, social and governance (“ESG”) initiatives as part of their businesses. Banks and other financial institutions are among those undertaking efforts to expand their ESG activities. Notably, some banks are taking these actions despite that, under the law today, they are subject to few if any regulations that promote ESG initiatives. None of the U.S. federal bank regulators, for instance, mandate expansion of ESG-related activities on the institutions they regulate and supervise.

This article focuses on the increasingly important ESG issue of climate change because it is an area that has recently drawn greater scrutiny from lawmakers and regulators. Indeed, President-elect Biden and his incoming administration are intensely focused on climate change issues, and Biden has even named a domestic “climate czar” who will be responsible for coordinating climate change-related actions across U.S. federal agencies and Congress. Accordingly, we discuss the current and prospective regulatory posture towards banks with respect to climate change to illustrate how ESG activities may (or may not) be impacted by regulation and supervision. We also discuss the ESG-related duties of bank boards of directors and officers and steps banks can take to mitigate litigation and enforcement risks. While the focus of this article is on climate change, the approach to this concern by banks should apply to other ESG issue areas beyond climate change.

**Banks and Climate Change**

Many banks have committed publicly to taking actions to counter climate change and to reducing their carbon footprints. There appear to be a number of potential factors driving the increased ESG activity in this space, in addition to movements for social and environmental justice and related advocacy efforts, including shifts in consumer
sentiment, shareholder activism and changes to the mission and culture of some firms.\textsuperscript{1} Industry groups are also actively organizing bank efforts in this regard.\textsuperscript{2}

The initiatives vary in scope, ranging from decreases in providing financing to the fossil fuel industry to pushing for adherence to the Paris climate accords and substantial investment in “green” technologies. Banks are also working together to advance this effort. For example, a number of U.S.- and non-U.S.-headquartered banks, working through the Partnership for Carbon Accounting Financials (the “PCAF”), recently launched what the PCAF describes is the first global standard to measure and report financed emissions resulting from loans and investments.\textsuperscript{3}

As we discuss in more detail below, there are also reasons from a risk management perspective for banks to consider their strategic decision-making in light of climate change-related challenges. These risk management considerations indicate that there are in fact some touchpoints between climate change and the expectations of banks under existing regulations and the supervisory priorities of bank regulators. Meanwhile some lawmakers, mainly Democrats, are pushing for stronger climate-related legislation and regulation that would more broadly impact banks and other financial firms. The recent U.S. election results may make implementation of at least some of these initiatives more likely. Moreover, globally active banks also will need to address the increasing focus on climate change regulation and supervision in other parts of the world.

The State of Regulation

Current Regulatory Framework

As noted above, in the United States, there are no sweeping legislative or regulatory mandates on banks to promote ESG initiatives, and the area of climate change is no exception.\textsuperscript{4} Nevertheless, climate change, like other ESG areas, already has some relevance to banks from a U.S. federal regulatory and supervisory perspective, particularly as it concerns a bank’s risk management and disclosure practices. As noted throughout this section, at least part of the challenge regulators face is exactly how to

\textsuperscript{1} Sustainability as BlackRock’s New Standard for Investing, BlackRock (2020), available here.
\textsuperscript{2} Complementary, Not Conflicting: Securities Lending and ESG Investing Coexist, The Risk Management Association (2020), available here (explaining that securities lending activities can be aligned with and promote ESG principles).
\textsuperscript{3} The Global GHG Accounting & Reporting Standard for the Financial Industry (Nov. 18, 2020), available here.
\textsuperscript{4} Indeed, the Office of the Comptroller of the Currency’s recent “Fair Access” proposal would make it more difficult for banks to not engage with the fossil fuel industry. 85 Fed. Reg. 75261 (Nov. 25, 2020). However, recent election results, as well as the negative response to the proposal by many in the banking industry, may make implementation of this proposal less likely.
approach climate change regulation beyond certain traditional areas of concern. However, at least one state financial regulator, the New York State Department of Financial Services, has pushed ahead and recently directed supervised firms to take specific steps to address climate financial risk.

As to applying more traditional bank risk frameworks to climate change, Kevin Stiroh, head of the Supervision Group at the Federal Reserve Bank of New York (the “FRBNY”), remarked early last year that “[c]limate change is already affecting economic and financial outcomes, and projections point to increasingly severe and unpredictable change.” Similarly, Federal Reserve Board (the “FRB”) Governor Lael Brainard has discussed the potential destabilizing effects of climate change and explained that assessing a bank’s risk management systems is an “essential element” of the FRB’s supervisory and regulatory duties, and that the FRB “expect[s] banks to have systems in place that appropriately identify, measure, control, and monitor all of their material risks,” which “risks may include severe weather events that can disrupt standard clearing and settlement activity and increase the demand for cash” and “potential loan losses resulting from business interruptions and bankruptcies associated with natural disasters, including risks associated with loans to properties that are likely to become uninsurable or activities that are highly exposed to climate risks.”

Two new terms have emerged to capture the major categories of climate financial risk. First, there is “physical risk,” which refers to “the potential for losses as climate-related changes disrupt business operations, destroy capital and interrupt economic activity.” For example, collateral, such as real estate underlying a loan, may be at increased risk of being damaged and thus losing value because of a natural disaster or other climate event. The second new category of risk that has emerged is “transition risk,” which is “the potential for loss resulting from a shift toward a lower-carbon economy as policy, consumer sentiment and technological innovations impact the value of certain assets and liabilities.”

Other, traditional risks are relevant as well. Take, for example, reputational risk, which refers to the risk of loss due to damage to the bank’s reputation. The basic idea is that if

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6 Lael Brainard, Governor, Federal Reserve Board, Remarks at “The Economics of Change” research conference sponsored by the Federal Reserve Bank of San Francisco (Nov. 8, 2019) available here (“As was the case with mortgages before the financial crisis, correlated risks from these kinds of trends could have an effect that reaches beyond individual banks and borrowers to the broader financial system and economy. As with other financial stability vulnerabilities arising from macroeconomic risks, feedback loops could develop between the effects on the real economy and those on financial markets.”).
7 Stiroh Remarks.
8 Id.
the trend of increasingly frequent and severe natural disasters persists, and a bank increasingly invests in or supports fossil fuels (rather than stabilizing or reducing its carbon footprint), then that bank may expose itself to greater reputational risk.

Banks are seeking to adapt to these emerging risks, including by working towards establishing enterprise-wide climate frameworks to ensure climate financial risk is better integrated into the institution’s strategic decision-making, and by considering the potential for business disruption due to natural disasters and other severe climate events to enhance operational resilience. A significant challenge in this context is that the typical tools of risk management and governance may need to evolve as “[t]raditional backward-looking models based on historical trends may no longer be reliable” and thus there is urgency to develop new, forward-looking approaches. In addition, physical and transition risks may “introduce new strategic risks associated with the challenges and opportunities of sectoral reallocations of economic activity, new production patterns and evolving industry exposures.”

As a precursor to the more prescriptive approach that may eventually come at the federal level, the New York State Department of Financial Services (the “DFS”) issued guidance concerning climate financial risk on October 29, 2020, making some of the above-described expectations explicit for the institutions the DFS regulates, which include New York-chartered financial institutions, New York branches and agencies of non-U.S. banking organizations, and other organizations licensed by the DFS. The guidance includes the DFS’s expectation “that all regulated organizations start integrating the financial risks from climate change into their governance frameworks, risk management processes, and business strategies,” including by conducting “an enterprise-wide risk assessment to evaluate climate change and its impacts on risk factors, such as credit risk, market risk, liquidity risk, operational risk, reputational risk, and strategy risk.”

In its guidance, the DFS explains that climate change is accelerating and that the economic costs of climate change-related disasters are increasing. The DFS also provides additional detail about the nature of physical and transition risks and states that firms are “not only exposed to the physical and transition risks of climate change, but they also may be actively exacerbating those risks by continuing to provide substantial financing to activities that intensify climate change.”

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9 Id.
10 Id.
Physical risks, the DFS explains, “can cause destruction of properties and assets, business disruption, supply chain disruption, increase in costs to recover from disasters, reduction in revenue, and migration,” which consequences in turn “can lead to lower household wealth and lower corporate profitability, translating into financial risk and losses.” These risks may carry systemic consequences, as “[a]dverse physical impacts of a weather event in one community may not necessarily be contained in that community, and losses at one financial institution may not be confined to that institution and may ricochet across the financial system, as correlated risks from these events could have an effect that may reach beyond an individual organization to the broader financial system and the economy.”

With regard to transition risks, the DFS notes that transitioning may lead to “stranded assets” in the fossil fuel and carbon-intensive industries, which are assets that “turn out to be worth less than expected as a result of changes associated with the energy transition.” The DFS estimates that the value of (eventually) stranded assets in the fossil fuel and carbon-intensive industries will range between $250 billion and $1.2 trillion and warns that “cumulative losses and costs could send broad, intersecting and amplifying financial ripples to financial institutions with exposures to these industries.”

To address these and the other risks posed by climate change, the DFS expects firms to start addressing climate financial risk, including by designating “a board member, a committee of the board (or an equivalent function), as well as a senior management function, as accountable for the organization’s assessment and management of the financial risks from climate change.” The DFS also expects firms to “start developing their approach to climate-related financial risk disclosure and consider engaging with the Task Force for Climate-Related Financial Disclosures framework and other established initiatives when doing so.”

Though mostly standing alone at the moment domestically, the DFS is not an outlier internationally. The European Central Bank (the “ECB”), for instance, also released guidance last year directed at financial institutions with significant operations in the European Union to address climate financial risk.12 The guidance explains “how the ECB expects institutions to consider climate-related and environmental risks—as drivers of established categories of prudential risks—when formulating and implementing their business strategy and governance and risk management frameworks” and “how the ECB expects institutions to become more transparent by enhancing their climate-related and environmental disclosures.” Notably, though it is not binding, the guidance sets expectations for all “significant institutions” that are directly supervised by the ECB, which may include certain large U.S. banks with significant operations in the EU.

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12 European Central Bank, Guide on climate-related and environmental risks, Supervisory expectations relating to risk management and disclosure, (May 2020), available here.
The EU also introduced certain enhanced disclosure rules last year, which require asset managers and other regulated firms, which may include banks, to disclose how sustainability risks are part of their investment decision-making process and to discuss in an “adverse impact statement” how their investment decisions impact sustainability factors.\(^{13}\) The rules take effect on March 10, 2021.

In the United States, banks that are public registrants under the U.S. federal securities laws already have obligations to make periodic and other disclosures regarding risks to their business and events and trends that affect or will affect their business.\(^{14}\) To the extent that climate change risks are material to a bank’s business, or climate change-related events or trends have had a material effect or will have a material effect on a bank’s business, the Securities and Exchange Commission would expect that bank to disclose and discuss such risks, events or trends as appropriate. Indeed, in a 2010 interpretive release, the SEC discussed how existing disclosure requirements might apply to climate change and noted that materials risks to an issuer’s business might include the impact of climate change legislation and regulation, the impact of international accords (e.g., the Paris Agreement), the consequences of regulatory or business trends, including legal, technological, political and scientific developments, and potential physical impacts of climate change. Nonetheless, commentators have debated whether these rules, which rely on a principles-based materiality standard, have in fact produced sufficient disclosure, or whether more prescriptive rules and guidance are needed with respect to climate risks to ensure investors receive accurate, comparable and sufficiently complete information.

**Push for Comprehensive Climate Financial Risk Framework**

As banks consider shifting their strategic activities and enhancing risk management and disclosure practices, Democratic lawmakers are pushing for climate change-related legislation and regulation to more comprehensively target climate financial risk and expand the climate risk-related supervisory responsibilities of U.S. federal bank regulators. President-elect Joe Biden also has made addressing climate change a top priority for his administration, though it remains to be seen how exactly his administration will seek to address the interconnections between climate change and the financial system.

Senate Democrats, in a recent report that seeks to provide a framework for Congress to establish sweeping climate change-related legislation, argue for several specific changes

\(^{13}\) We discuss some of the EU developments in our client update [here](#).

\(^{14}\) In addition, even if a bank is not a public registrant, the general anti-fraud rules under the federal securities laws may compel analogous disclosure in connection with the issuance of securities into U.S. securities markets.
to the regulation and supervision of financial institutions. The report recommends, among other things, that:

- The FRB and other U.S. bank regulators should follow their international counterparts and undertake more extensive efforts to understand climate financial risks;

- The SEC should update rules on how companies disclose climate risks and require rating agencies to incorporate climate financial risk into their rating methodologies;

- The FRB should take the lead in developing climate scenario analysis tools and conduct stress tests on individual financial firms to measure their resilience to climate risks;

- The U.S. bank regulators should improve their supervisory practices to incorporate climate risks; and

- The Financial Stability Oversight Council should assess risks to the financial system as a whole.

Some elements of the report’s recommendations arguably could be implemented by regulators without action from Congress. Indeed, staff at the Commodity Futures Trading Commission (“CFTC”) has stated that existing statutes already provide U.S. financial regulators with flexible tools and authorities that could be used to start addressing financial climate-related risk now. CFTC staff explains, for instance, that regulators already enjoy broad authority to prudentially supervise and regulate banking and other financial institutions and could use existing authorities, like those under the Dodd-Frank Act, to prescribe more stringent prudential standards.

FRB Chair Jerome Powell recently indicated the possibility of federal bank regulators taking stronger action on climate change. Speaking at a press conference following the November 5, 2020 Federal Open Market Committee meeting, Chair Powell stated that “the public will expect and has every right to expect that in our oversight of the financial system we will account for all material risks and try to protect the economy and the public from those risks.” “Climate change”, Chair Powell said, “is one of those risks.” Though, Chair Powell also went on to note that the FRB is still “very actively in the

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15 Senate Democrats’ Special Committee on the Climate Crisis, The Case for Climate Action, Building a Clean Economy for the American People (Aug. 25, 2020), available here.
17 In its Supervision and Regulation Report released in November 2020, available here, the FRB specifically discusses climate change risk as a potential risk to financial stability.
early stages” of thinking about how to incorporate climate change into its supervisory framework.

On December 15, 2020, the FRB announced that it had formally joined the Network of Central Banks and Supervisors for Greening the Financial System (the “NGFS”). The NGFS, launched in December 2017, is comprised of leading central banks and financial regulators and focuses its work on sharing best practices around, and contributing to the development of, climate risk management in the financial sector.

Regulating climate financial risk may prove difficult and there likely would be challenges to developing the necessary supervisory expertise and appropriately tailoring any new regulations and supervisory practices. For instance, some commentators have pointed out that methodological challenges in developing climate scenario analysis could make the results of climate stress testing subjective and highly variable. Others argue that lawmakers should proceed cautiously because of the “transition risks” described above, which reflect the costs and potential destabilizing effects of transitioning towards a greener economy. A hasty transition prompted by strong regulation could do more harm than good, the argument goes. Others argue that “physical risks” significantly outweigh transition risks, and therefore robust regulation is warranted.

The FRBNY’s Mr. Stiroh, speaking at a more recent conference, emphasized the scale of the challenge ahead:

“[Climate financial risk] is complex in the sense of many interconnections and feedback loops; the likely existence of non-linearities and tipping points; and massive uncertainty about key factors like the timing of climate impacts, policy choices, technological change, and adaptive responses by consumers and businesses. All of this tests our capacity to understand and manage the risks. At the same time, this is a complicated undertaking from an implementation perspective. Success will require us to process and analyze vast amounts of granular data and aggregate across business lines, sectors, and jurisdictions; to implement new governance and organizational structures; and to invest in our workforce to develop new skills and new expertise.”

Mr. Stiroh, who also is a co-chair of the Basel Committee’s Task Force on Climate-Related Financial Risks, explained that efforts were underway by the Task Force’s

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international working group to “consider the extent to which climate-related financial risks are incorporated in the existing Basel Framework and identify effective supervisory practices to mitigate such risks.” He noted, however, that the Task Force “does not currently have a view on potential prudential treatments or supervisory expectations related to the mitigation of climate-related financial risks.”

Another potential approach to addressing climate financial risk is enhanced disclosure requirements. Some commentators have argued that current disclosure practices are insufficient and understate the risks banks face from climate change.20 Specifically, these commentators argue that firms could do more to disclose their exposure to carbon-based assets and in describing any plans they may have to transition away from such assets.

Discussing the need for regulators to better understand climate financial risk and the importance of robust disclosure, SEC Commissioner Allison Herren Lee recently said this:

“Where to start? Data. All policy should proceed from a foundation and clear-eyed analysis of accurate, reliable data. Policy makers need it and, importantly, those steering the capital that drives our economy need it. That need is borne out by the extraordinary demand we see in markets today for climate-related disclosure. And the demand is not limited to climate, but also includes demand for ESG-related information more broadly. There is really no historical precedent for the magnitude of the shift in investor focus that we’ve witnessed over the last decade toward the analysis and use of climate and other ESG risks and impacts in investment decision-making.”21

As noted above, the idea of enhanced disclosures around sustainability has already taken hold in the EU.

The Financial Stability Board (the “FSB”) recently issued a report to advance the international conversation around climate financial risk, noting that both firms and regulators need better disclosure and data around climate-related risks and exposures to effectively mitigate such risks.22 The report also adds to the conversation by focusing on the potential for cross-border transmission of climate-related shocks to the financial system. As a next step, the FSB states that it will work to assess the availability of data

20 Steven M. Rothstein and Dan Saccardi, Climate change threatens U.S. banks far more than they’re disclosing, CNBC (Oct. 19, 2020), available here.
21 Allison Herren Lee, Commissioner, SEC, Keynote Remarks at PLI’s 52nd Annual Institute on Securities Regulation (Nov. 5, 2020), available here.
(as well as any data gaps) relevant to monitoring climate-related risks to financial stability, which work the FSB expects to complete by October 2021.

Ultimately, whether lawmakers or regulators adopt new legislative or regulatory solutions in the United States remains uncertain. But the focus on climate change and climate financial risk seems to be increasing.

Considerations for Promoting and Enhancing ESG Initiatives

As described above, banking institutions are increasingly promoting a number of ESG initiatives on climate change, even where regulators have not yet taken action. But addressing climate change risks goes far beyond a mere marketing or business strategy. The management of physical, transitional and reputational risks is a complex, rapidly evolving and increasingly multifaceted exercise, which must be deeply rooted in the everyday activities of the bank and driven by senior management. Consideration of these risks should be built into investment and loan decisions, sectoral allocation and importantly, existing compliance systems.

In addition to these risks, banks and financial institutions must consider and work to avoid litigation risks. An emerging international web of regulations, disclosure requirements, soft law instruments and industry standards dealing with climate change exposes businesses to potential government sanctions, lawsuits under domestic tort and securities laws, contract claims and investor pressure.

For example, many global banks, including all eight U.S. G-SIBS, have signed onto the Task Force for Climate-Related Financial Disclosures, which has published recommendations for how companies should voluntarily disclose climate risks. The recommendations span governance, strategy, risk management and targets, and many financial firms have started disclosing under this framework to various extents.

Similarly, soft law measures, such as the U.N. Sustainable Development Goals 7 (Affordable and Clean Energy) and 13 (Climate Action), and the U.N. Guiding Principles on Business and Human Rights, even though they do not impose specific obligations under national or international law, may increasingly influence courts in their determinations of proper corporate behavior.

Climate change litigation continues to pose a substantial risk. More than 1400 climate-related cases have been filed worldwide, including 119 cases in the United States in 2019 alone. For example, in Abrahams v. Commonwealth Bank of Australia, shareholders sued the bank because its annual report did not disclose climate change-related risks. The
shareholders dropped the suit after Commonwealth Bank of Australia included an acknowledgement that climate change posed a significant risk to the bank’s operations in its 2017 annual report.

Banks and financial institutions must also consider how existing fiduciary duty obligations may be applied to their climate-related activity.

Therefore, corporate programs must be rigorously structured to align with the international efforts to address climate change to ensure that they are defensible before courts and international tribunals. Against this backdrop, counsel have an essential role to play in comprehensive and effective ESG strategy, as their insight is important to understand the requirements of the relevant standards and to ensure that legal risk is addressed simultaneously with physical, transitional and reputational risk.

In general, when addressing climate change, financial firms should have in place: (i) a policy commitment to meet their responsibility; (ii) reporting and disclosure efforts to comply with obligations and to inform stakeholders; (iii) a due diligence process to identify, prevent and mitigate potential adverse impacts; and (iv) a process to enable banks to remediate the impacts they cause or the negative consequences to which they contribute.

Importantly, banks should take care in drafting policies and public statements not to overstate their goals or their practices in order to avoid the risk that they will not be followed and thus create a potential hook for future litigation. Such statements are too often drafted as public relations and marketing documents without consideration of litigation risks that might ensue. Like any other disclosure documents, these statements should be carefully reviewed by in-house or external counsel to ensure that they are accurate, defensible and do not make promises that cannot be fulfilled. The statements can include language on the “aspirational” nature of the goals set and disclaimers pointing out estimates and assumptions.

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Please do not hesitate to contact us with any questions.