Prepare for Changes as Biden Administration Sets Sight on ESG

It's been fewer than two decades since the term ESG, or Environmental, Social and Corporate Governance, was coined in a landmark report commissioned by the United Nations. ESG has become a hot topic for politicians and regulators, as events like natural disasters and protests on racial and social inequity have led to public calls to action for fundamental changes to the way society interacts with the environment and how different segments of society interact with each other.

There is rising public, political and investor pressure on firms in every sector to take ESG seriously and modify their behaviors accordingly. Financial services firms' role in ESG transformation transcends their direct impact on climate change, social equity and governance. These firms are unique because they also fund investments and loans in other industries that in turn have downstream ESG impacts. The 2004 report that coined the term ESG was drafted by leading global financial firms in an effort to develop guidance and considerations for how ESG concepts could be better incorporated into financial services.

Firms may also be realizing that pursuing an ESG-conscious agenda doesn't need to be at the expense of corporate profitability. In fact, there is evidence to suggest that including ESG in corporate strategy can positively impact bottom lines. A 2020 study from Harvard Law School demonstrated that firms that earn higher ESG scores enjoy better share price performance and higher profitability than their peers with lower scores.[1]

Financial services firms' evolving outlooks on ESG matters are, at least partially, driven by newly enacted or anticipated rules and regulations. European governments and regulators have been ahead of their U.S. counterparts on enacting such rules, but the Biden administration has made its intentions to focus on ESG matters clear. U.S. firms should expect new standards in coming years and can look to Europe as a guide on what ESG changes might soon be happening on this side of the pond.

[1] Harvard Law School Forum on Corporate Governance, "ESG Matters," Jan. 14, 2020.

European Regulators Ahead in the Game

In June 2021, the Bank of England (BoE) revealed the framework and scenarios for its first climate-change-related stress test for the United Kingdom's biggest banks and insurers. The biennial stress test will look at three potential scenarios for the next 30 years in an effort to better understand two primary risks: transition risks resulting from policy changes to promote zero emissions by 2050 (e.g., the introduction of carbon taxes) and physical risks of higher global temperatures if no policy action is taken. Initially, the BoE's test will not produce binding capital or liquidity constraints as a result of findings.

The Prudential Regulatory Authority in the United Kingdom has already codified how banks should manage climate-related financial risks, and U.K. banks are expected to comply with those guidelines by the end of this year. In addition to focusing on the *E* in ESG, the BoE and other U.K. regulators have also begun to tackle the *S*. These regulators recently published a discussion paper[2] that outlines rules that will be forthcoming next year on diversity and inclusion.

Across the rest of Europe, the European Commission (responsible for proposing and enforcing legislation within the European Union) has introduced a "Green Asset Ratio" to measure how much the region's banks lend to climate-friendly companies and projects. In May 2021, the European Banking Authority (EBA) published its first estimates of the ratio for different firms; in some cases, these estimates varied widely from the firms' own estimates, raising concerns about data accuracy and reliability. While the first estimates were provided anonymously, the EBA will be publishing the green ratios with names attached starting next year. Also in 2022, the European Central Bank is planning to conduct its first climate-related stress test of individual banks under its supervision.

Europeans have also led the way on ESG-related disclosure requirements. Asset managers and advisers across the economic bloc started complying with new ESG disclosure standards in March 2021 while U.K.-based investment firms will have to abide by similar but narrower requirements starting in 2022.

ESG initiatives in the EU have not been without controversy. An unintended consequence of the regulation is that greenwashing – misleading the public on the environmental soundness of a firm's practices – has become much more prevalent. The EU's recently introduced antigreenwashing rules have narrowed the definition of what counts as ESG-compliant investments, in an effort to combat this trend. These new rules forced the region's asset managers to lower the amount they could report as ESG assets by $2 trillion last year, according to a July report by the Global Sustainable Investment Alliance.[3] The downward adjustment of EU asset managers catapulted U.S. asset managers to the top of the ESG investment rankings globally; however, the enactment of similar anti-greenwashing rules on a global scale could impact U.S. ESG metrics in a similar fashion.

[2] Bank of England, DP2/21 – Diversity and Inclusion in the Financial Sector – Working Together to Drive Change, July 7, 2021.

[3] Global Sustainable Investment Alliance, *Global Sustainable Investment Review 2020*.

U.S. Politics in Motion

Under the previous administration, U.S. regulators were hesitant to acknowledge climate risks and other ESG concerns, as former President Donald Trump opposed these efforts openly. In fact, the Office of the Comptroller of the Currency (OCC) finalized the Fair Access Rule last year to bar financial firms from denying loans to certain sectors or businesses (effectively preventing the banking industry from cutting off services to oil and gas companies). Prior to going into effect, the rule was killed by Acting Comptroller of the Currency Michael Hsu, who was appointed by President Joe Biden.

In May 2021, Biden issued an executive order asking regulators to start assessing climate-related financial risks and to integrate those considerations into their policy and supervision. In June 2021, the U.S. House of Representatives passed H.R. 1187, Corporate Governance Improvement and Investor Protection Act, in which Title I tackles ESG Disclosure Simplification[4]. Other notable titles within the bill related to ESG include Shareholder Political Transparency, Greater Accountability in Pay, and Climate Risk Disclosure. The House vote was as tight as could be: 215-214, with four Democrats and every Republican opposing the bill.[5] The bill was received in the Senate and referred to the Committee on Banking, Housing and Urban Affairs. Yet an equally split Senate leaves the future of the bill in question.

U.S. Regulators Catching Up

Despite legislative uncertainty, U.S. regulators have recently been getting more active on ESG. The *E* has been the focus of most regulatory efforts lately – perhaps because it is the most tangible to define and a baseline already exists. The OCC, which regulates all nationally chartered U.S. banks, joined the network of central banks and regulators focused on climate change in July 2021, following in the footsteps of the Federal Reserve Board (FRB) (the primary regulator for state-chartered banks), which had done so in December 2020. The OCC also established a new senior position within the agency tasked with monitoring climate-change risk. The FRB has set up two committees on the subject, one focusing on macroprudential risks to the financial system resulting from climate change and the other focusing on risks to individual banks supervised by the central bank. FRB Chairman Jerome Powell said in a July 15, 2021 congressional testimony that the central bank will also require climate-related stress tests in the future but added that the FRB wasn't in a position to do so just yet.

The Securities and Exchange Commission (SEC) has been producing guidance on climate-related disclosures since 2010, but in March 2021 it issued a public request for comment on whether the existing disclosure requirements are sufficient to adequately inform investors about material risks. One intent of the SEC's review is to look not only at climate change, but also to assess the broader ESG spectrum and how climate-change disclosure fits into the wider agenda. However, at least one SEC commissioner has recently questioned if the agency is appropriately placed to set disclosure requirements around ESG at this time. In a June 2021 National Investor

[4] U.S. Congress, H.R. 1187 – Corporate Improvement and Investor Protection Act.

[5] Clerk, U.S. House of Representatives, Roll Coll 169, Bill Number: H.R. 1187.

Relations Institute conference speech, Commissioner Elad Roisman pointed out that, unlike other countries that have taken legislative action to require ESG frameworks, in the U.S. ESG-related legislation has passed only the House of Representatives to date. Roisman's view is that the decision to require ESG disclosures should be in the hands of elected officials, and that these efforts should not be interceded by the opinions of appointed SEC commissioners.[6]

Although the *S* in ESG has not traditionally led U.S. conversations around ESG reform, recent developments have shone the spotlight on racial injustice, sexual misconduct against women and rising inequality due to economic policies. These developments have acted as catalysts for many public calls for action, which have not gone unnoticed by regulators. In his August 3 testimony before Congress, Acting Comptroller Hsu listed multiple areas of ESG-related reform the agency was targeting, including inequality in banking, predatory and discriminatory practices, inclusion and increased access to credit for the unbanked and underbanked, and improved diversity in bank board rooms. However, it's still unclear how these social reforms will be woven into actionable, enforceable rulemaking.

The *G* component of ESG attempts to tackle the challenge of ensuring that firms have the right people in the room when key decisions are made on behalf of a firm's stakeholders. Effective governance is a key element in many high-priority regulatory topics like conduct, data privacy, cybersecurity and financial crime and has been woven into notable legislation on the aforementioned. As governance has already been a high-priority agenda item for regulators for a while now, it is not surprising that the topic has been the least discussed of the three components as of late. However, one governance area that may be revisited as Biden appointees at supervisory agencies look for further governance reform is limits on executive pay at financial firms, a key element of the 2010 Dodd-Frank Act that was never finalized by regulators.

What Firms Should Do Now

In light of global regulatory trends and increasing importance to stakeholders, firms have the opportunity to embed ESG into corporate strategies based on the priorities of their stakeholders, and to strengthen risk governance programs with a balanced approach across Environmental, Social and Governance factors. Effective ESG risk management starts at the top, with the board of directors driving ESG risk culture throughout the firm. Consistency in messaging and clear objectives are crucial to ensuring that the entire organization is working toward an aligned vision and common goal.

[6] U.S. Securities and Exchange Commission, "Can the SEC Make ESG Rules That Are Sustainable?" June 22, 2021.

ESG objectives will be unique to each institution, but key objectives to consider based on industry best practices include the following:

ESG CONSIDERATIONS

Environmental

Sustainability Initiatives
- Energy efficiency
- Green building opportunities

Environmental Stewardship
- Waste management
- Recycling
- Reducing electronic waste
- Reducing water usage
- Promoting biodiversity
- Preventing deforestation

Sustainable Finance
- Investments to support the transition to a low-carbon economy
- Managing climate-related financial risk (both transitional and physical)

Social

Communities
- Community investment
- Community relations
- Responsible investment

Customers
- Equality and fair access to banking products
- Consumer financial protection
- Customer privacy
- Data protection
- Selling practices and product labeling

Employees
- Diversity and inclusion
- Workplace health and safety
- Human rights (including in the supply chain)
- Employee engagement and training

Governance

Business Ethics
- Code of conduct
- Transparency and reporting
- Lobbying
- Political contributions
- Shareholder rights

Enterprise Risk Management
- Risk management
- Anti-money laundering policies and practices
- Anti-bribery and corruption policies and practices

Board and Executive Management
- Board diversity
- Board quality and effectiveness
- Executive compensation

Once the stage has been set, firms should focus on how to translate board-level ESG objectives most effectively into clear, understandable guidelines and metrics that can be implemented by business units and operating personnel. Using credit risk as an example, firms can review their current credit portfolios to identify climate-related financial risks across industries and clients and make the necessary adjustments to ensure alignment with ESG strategic objectives and risk appetite. To facilitate this analysis, firms will need to develop new metrics and stress testing methodologies for assessing ESG impact as part of their ongoing credit risk measurement and monitoring activities. Firms can also step up their sustainable lending programs to support the transition to a low-carbon economy.

From a compliance standpoint, firms should also look to partner with industry groups that will keep them informed on regulatory developments on the ESG front as they ramp up under the current administration. As more and more financial firms have their own ESG programs and have been working to become more ESG-oriented, compliance personnel should also contribute to the discussion among regulators and offer ideas based on their own already established strategy to help shape future regulation. Compliance's role in ESG reform mustn't wait until concrete regulation exists. Departments should be proactively assessing the impact of ESG-related reforms on existing firm policies and practices.

For example, core compliance programs likely to be impacted by a firm's evolving risk appetite around ESG include sales practices, business entertainment, new products and services activities, vendor management, customer complaints, and incentive compensation.

In the past decade banks and other financial firms have been mostly in a defense mode against rules and regulations emanating from agencies. With ESG, they can be on the offensive as the private sector in many ways has been ahead of the government, at least in the U.S., when it comes to ESG priorities.

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