Environmental, Social and Governance (ESG) Implications for Banking

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Introduction

- ESG disclosure driven by investors
- US agencies slow to respond as compared to EU
- Entering a new phase of ESG from a legal and regulatory standpoint
- Politicization of ESG both at state level and in Congress
- Climate change is a priority but important to also consider the "S" and "G"

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Federal Banking Agencies (FBAs) Climate Change Updates

OCC/FCID

- Proposed principles are a high-level framework for large banks ($100 billion in total consolidated assets)
- Will lead to guidance for large banks tailored to specific institutional circumstances
- <u>All</u> banks should consider and, if appropriate, incorporate climate-related risk into ERM
- Modeled on the Task Force on Climate-related Financial Disclosure (TCFD)

OCC/FCID

- ESG Governance Requirements
  - Board and management
  - Policies and procedures
  - Risk Management
  - Credit risk – impact on loan underwriting and portfolio monitoring
  - Strategic planning
- Disclosure considerations
- Climate scenario analysis

Federal Reserve

- March 2021 Fed Statement→ Financial Stability
  - Key takeaways
    - Federal Reserve's Financial Stability monitoring framework is flexible enough to broadly incorporate climate-related risks
    - More research needed in order to incorporate climate risks fully into financial stability monitoring (improvements to data and models)
- Possible impact under various scenarios
  - Decline in output, investor losses
  - Wide financial system vulnerabilities
- Challenges — hard to quantify climate-related risks and investment needed in additional studies

Federal Reserve – Climate Scenario Analysis 2023

- On September 29, 2022, the Federal Reserve Board announced in a press release that six of the largest US banks will participate in a climate scenario analysis pilot to assess financial risks
    - The pilot, which will be launched in early 2023, is designed to enhance the ability of supervisors and firms to measure and manage climate-related financial risks
- The 6 institutions will undergo the climate scenario analysis exercise, which will assess the resilience of financial institutions under different hypothetical climate scenarios
- Details and more information TBD — will be disclosed at pilot launch

Looking Abroad – EU and Bank of England Climate Biennial Exploratory Scenario (CBES)

- European Banking Authority
  - Published draft ESG disclosure standards which will include:
    - Lending practices to entities deemed to pose a high risk to climate change and carbon-related sectors
    - Real Estate collateral and energy efficiency of such collateral
    - Financed GHG emissions
    - Exposure in banking book (top 20 carbon-intensive firms globally)

EBA | EUROPEAN BANKING AUTHORITY

- Bank of England 2021 Climate Biennial Exploratory Scenario
  - Certain of the UK's largest financial institutions conducted an intensive climate-related stress test
    - aimed at measuring the financial exposures of participants and the financial system to climate-related risks
    - understanding the challenges to participants' business models from these risks
    - engaging with participants to assist them in enhancing their management of climate-related financial risks
  - Participants explored both transition and physical risks
    - Over 3 different 30-year scenarios
      - Early Action, transition to net-zero economy started in 2021
      - Late Action, action delayed until 2031
      - No additional action, no new policies

SEC Proposed Climate and GHG Disclosure Rule

SEC Climate Change Proposal

- On March 21st, the SEC released its long-awaited and sweeping 510-page proposal on climate-related disclosures
- Prior to issuing, SEC received comments from more than 600 companies over the last year
- This proposed rule is the first time public companies in the US (and foreign private issuers reporting here) would be subject to such detailed disclosure requirements, though multinational companies face similar rules in Europe
- Both the SEC's authority to issue a rule of this nature as well as the very detailed requirements of the proposal are controversial and likely to be litigated

21334 Federal Register / Vol. 87, No. 69 / Monday, April 11, 2022 / Proposed Rules

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 210, 229, 232, 239, and 249

[Release Nos. 33–11042; 34–94478; File No. S7–10–22]

RIN 3235–AM87

The Enhancement and Standardization of Climate-Related Disclosures for Investors

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission ("Commission") is proposing for public comment amendments to its rules under the Securities Act of 1933 ("Securities Act") and Securities Exchange Act of 1934 ("Exchange Act") that would require registrants to provide certain climate-related information in their registration statements and annual reports. The proposed rules would require information about a registrant's climate-related risks that are reasonably likely to have a material impact on its business, results of operations, or financial condition. The required information about climate-related risks would also include disclosure of a registrant's greenhouse gas emissions, which have become a commonly used metric to assess a registrant's exposure to such risks. In addition, under the proposed rules, certain climate-related financial metrics would be required in a registrant's audited financial statements.

DATES: Comments should be received on or before May 20, 2022.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's internet comment form (*https://www.sec.gov/rules/submitcomments.htm*).
- Send an email to *rule-comments@sec.gov*. Please include File Number S7–xx–xx on the subject line.

Paper Comments

- Send paper comments to Vanessa A. Countryman, Secretary, Securities

the Commission's website (*https://www.sec.gov/rules/proposed.shtml*). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street NE, Washington, DC 20549 on official business days between the hours of 10 a.m. and 3 p.m. Operating conditions may limit access to the Commission's Public Reference Room. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly.

Studies, memoranda, or other substantive items may be added by the Commission or staff to the comment file during this rulemaking. A notification of the inclusion in the comment file of any such materials will be made available on our website. To ensure direct electronic receipt of such notifications, sign up through the "Stay Connected" option at *www.sec.gov* to receive notifications by email.

FOR FURTHER INFORMATION CONTACT: Elliot Staffin, Special Counsel, Office of Rulemaking, at (202) 551–3430, in the Division of Corporation Finance; or Anita H. Chan, Professional Accounting Fellow or Shehzad K. Niazi, Acting Deputy Chief Counsel, in the Office of the Chief Accountant, at (202) 551–5300, U.S. Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: We are proposing to add 17 CFR 210.14–01 and 14–02 (Article 14 of Regulation S–X) and 17 CFR 17 CFR 229.1500 through 1506 (subpart 1500 of Regulation S–K) under the Securities Act [1] and the Exchange Act,[2] and amend 17 CFR 239.11 (Form S–1), 17 CFR 239.18 (Form S–11), 17 CFR 239.25 (Form S–4), and 17 CFR 239.34 (Form F–4) under the Securities Act, and 17 CFR 249.210 (Form 10), 17 CFR 249.220f (Form 20–F), 17 CFR 249.306 (Form 6–K), 17 CFR 249.308a (Form 10–Q), and 17 CFR 249.310 (Form 10–K) under the Exchange Act.

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Disclosure Rule – Key Elements and How to Prepare

- Climate risk
- Climate risk management
- Greenhouse gas emissions
- Targets & goals
- Governance
- Financial metrics – impacts, expenditures & estimates
- Compliance schedule

Physical and Transition Risks

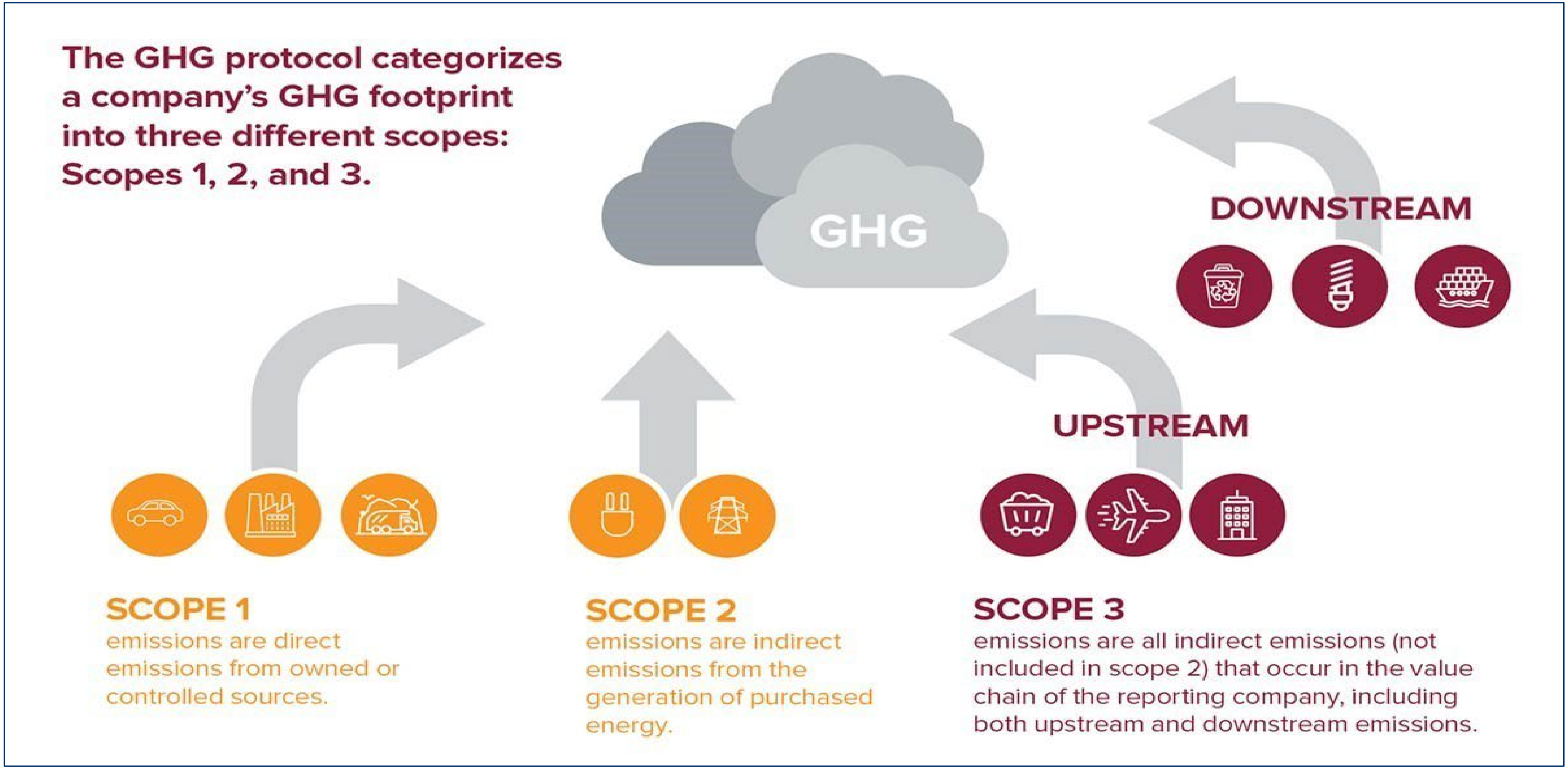
Physical Risks

- **"Physical risks"** are both acute risks and chronic risks to the registrant's business operations or the operations of those with whom it does business.
- **Acute risks** are event-driven and may relate to shorter term extreme weather events, such as:
  - Hurricanes
  - Floods
  - Tornadoes
- **Chronic risks** relate to longer term weather patterns and related effects, such as:
  - Sea level rise
  - Drought
  - Increased wildfires
  - Decreased arability of farmland
  - Decreased availability of fresh water

Transition Risks

- **"Transition risks"** are the *actual or potential* negative impacts attributable to *regulatory, technological, and market* changes to address the mitigation of, or adaptation to, climate-related risks, such as:
  - Increased costs attributable to changes in law or policy
  - Reduced market demand for carbon-intensive products
  - The devaluation or abandonment of assets
  - Risk of legal liability and litigation defense costs
  - Competitive pressures associated with the adoption of new technologies
  - Reputational impacts that might trigger changes to market behavior, consumer preferences or behavior, and registrant behavior
- Note that these requirements are distinct from the financial statement requirements to reflect the impact of climate.

Disclosures Required for Scopes 1, 2 and (sometimes) 3 Emissions



Financial Institution Comment Letters to SEC Proposed Rule

- The SEC should base its climate-related disclosure rules on the TCFD framework in conjunction with industry-specific metrics drawn from the SASB. (*Bank Policy Institute, BlackRock, Bloomberg, Credit Suisse*)
- The SEC should mandate disclosure of only Scopes 1 and 2 emissions. (*American Bankers Association, Bank Policy Institute, Blackrock, Institute of International Bankers, PIMCO*)
- The SEC should adopt a wide safe harbor for climate-related disclosures. (*American Bankers Association, Bank of America, Bank Policy Institute, Blackrock, Deutsche Bank)*
- Climate-related disclosures and accounting must be scalable to the size and complexity of the institution. *(American Bankers Association)*
- Longer transition periods are needed, given the nascent state of climate-related financial risk management. (*American Bankers Association, Bank of America, Bank Policy Institute*)
- The SEC should require that incremental mandated disclosures of climate information be disclosed outside of existing securities filings. (*American Bankers Association, Bank Policy Institute*)

ESG: Regulatory Enforcement, Legal Risk & Green Marketing

Environmental: Green Marketing

- Deutsche Bank
  - Former global head of sustainability for unit of Deutsche Bank alleged company made misleading statements in its 2020 report that more than half of the group's US $900 billion in assets had been invested under ESG criteria
  - In December 2021, DOJ informed Deutsche Bank that it may have violated a criminal settlement for failing to inform prosecutors of its failure to live up to ESG disclosures
  - In March 2022, the bank agreed to extend the term of its outside compliance monitor on this basis
  - In June, German authorities raided Deutsche Bank for evidence in support of green marketing allegations
- Similar investigations of Goldman Sachs and BNY Mellon

Environmental: Green Marketing

- Vale SA (April 2022)
  - SEC charged Vale, a Brazilian iron ore producer, with securities fraud
  - Alleged false and misleading statements and/or omissions related to the safety and stability of dams holding toxic waste and to compliance with environmental regulations
  - Alleged concealment of material facts from Vale's auditors and signed false certifications
  - SEC pointed to statements in Vale's sustainability reports, investor presentations, leadership's verbal comments, SEC filings and an ESG webinar
  - Demonstrates SEC's willingness to look beyond SEC filings to bring a case

VALE

Environmental: Green Marketing

- Environmental activists and other stakeholders often critique the use of ESG marketing terms including green, clean, sustainable, environmental, or eco-friendly
  - Can arise in advertisements but also in ESG disclosure including in public filings, sustainability reports, company websites
  - In light of this, public filers should exercise caution when including "green" or similar statements in disclosures
  - Consider potential regulatory and litigation risks if investors rely on such terms when making investment decisions
- Key takeaway
  - Entering into a phase of ESG where regulators, investors and environmental activists are likely to question or challenge ESG marketing claims

Key Takeaways for Financial Institutions

Key Takeaways for Financial Institutions

- Despite politicization and anticipated legal challenges to ESG regulations, investor initiatives and regulatory guidance needs to be considered
- The “ostrich” approach might lead to additional risk and potential liability
- Employee and board education is essential
- ESG governance
  - Board committee role
  - Management roles and responsibilities
  - Reporting lines
  - Modification of existing reports/creation of new reports
- Qualitative and quantitative data — What to consider

Key Takeaways for Financial Institutions – Taking ESG to the Next Level

- Consideration of processes a company utilizes to identify and address climate change risks and potential liabilities
- Leverage existing corporate governance infrastructure
- Climate change targets and goals – best practices
- Risks related to RECs & offsets and appropriate due diligence
- Substantiation
- Stress testing/climate scenarios

The “S” in ESG→ Diversity, Equity and Inclusion (DEI)

Understanding the Importance of the “S” in ESG→ Diversity, Equity and Inclusion

- Many companies, including financial institutions, have put resources and focus on DEI (proactive and reactive)
- A meaningful DEI program vs. check-the-box
- Equity and inclusion
- Impact to local communities
- Latest developments relating to board diversity
- DEI opportunities explained

DEI & Workplace Culture Examples

- California Department of Fair Employment and Housing sued AB in July 2021 (set for trial in February 2023)
  - Alleged company paid women less than their male counterparts and provided them with fewer opportunities to advance
  - Alleged company ignored complaints by female employees of widespread sexual harassment, discrimination and retaliation
    - Male employees, including executives, engaging in sexual banter and making derogatory jokes about women
    - “Cube crawls” in 2013 involving heavy drinking and inappropriate advances towards members of the opposite sex
    - “Cosby” suite rented during company’s annual event in 2013
    - HR Department accused of failing to keep reports of sexual harassment confidential, resulting in retaliation by managers against those who reported misconduct
    - Employees reported to press that some complaints about AB’s hostile work environment went unreported due to fear of retribution

DEI & Workplace Culture Examples

September 2021

- SEC began investigating AB’s disclosures related to how it handled allegations of sexual misconduct and discrimination
  - Did AB and its executives properly disclose allegations of workplace harassment and gender-pay issues in its 10K or did AB improperly rest on generalized statements of risk?
  - Should the allegations have been shared earlier with investors and other parties?
  - What representations were made in 10Ks related to culture, health and safety?
  - Who was involved in managing whistleblower complaints when the complaints were made?
  - Who knew what and when?
  - What was AB saying externally in the press compared to what it knew internally once the CA lawsuit became public?

DEI & Workplace Culture Examples

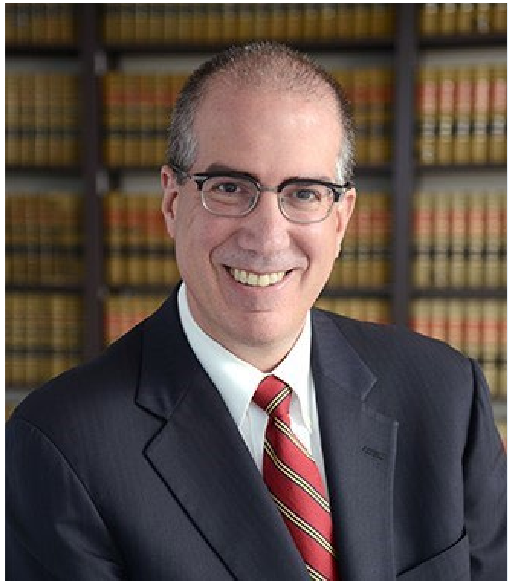
- Wells Fargo
  - Under criminal investigation by NY USAO for holding sham job interviews to falsely create impression it was considering diverse applicants and to boost its diversity statistics in anticipation of possible regulatory audits
    - Seven former bank employees reported being instructed to conduct interviews with black candidates despite the fact that someone else had already been selected for position
    - Wells Fargo then fired whistleblower/alleged retaliation
  - Shareholders sued Wells Fargo alleging that company made false and misleading statements about its commitment to diversity and its compliance with a 2020 policy requiring that at least half of interview candidates must represent "a historically underrepresented group."
- NYPD
  - Under investigation by DOJ for its handling of reports of gender bias and the shaming of victims
  - Allegations that NYPD failed "to conduct basic investigative steps" and instead engaged in "shaming and abusing survivors and re-traumatizing them during investigations."

Workplace Culture→ DEI

Takeaways

- Now is the time to review existing DEI and other employee programs and consider whether revisions are necessary
- Benefits of being proactive vs. reactive
- Regulators, such as the SEC, are focusing on DEI, including as it relates to green marketing
- Benefits of a full stakeholder analysis and how to conduct

Contacts



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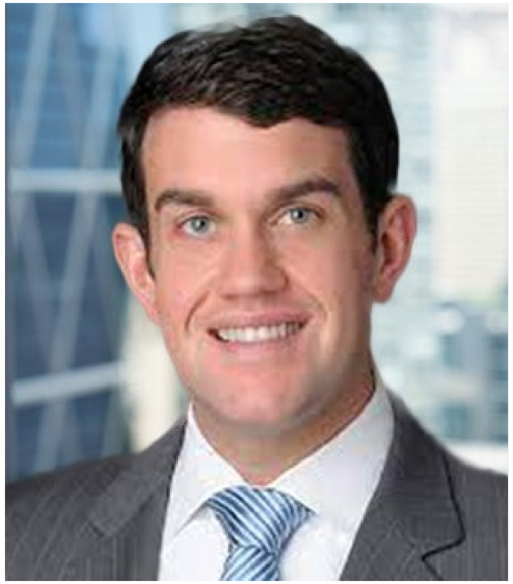

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