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Creating a climate of change digest

Creating a Climate of Change Digest: Climate risk regulatory developments in the financial services industry

Recent developments at the US Securities and Exchange Commission (SEC) reiterate the agency's commitment to addressing environmental, social, and governance (ESG) matters and more formally incorporating coverage of such matters into its regulatory regime. The Climate and ESG Task Force in the agency's Division of Enforcement was announced in March 2021 with the mandate to "identify material gaps or misstatements in issuers' ESG disclosures."[1] The Task Force has since executed at least two enforcement actions during the second quarter of 2022.[2] Taken together, the enforcement actions underscore the importance of precision and consistency concerning ESG-related reports, statements, and processes that have the potential to impact investment decisions.

On May 25, 2022, the SEC issued two press releases outlining (1) proposed changes to existing disclosure requirements, concerning ESG investment practices for select investment advisers and investment companies; and (2) a proposed update to the Investment Company Act "Names Rule."[3] Both proposals have a 60-day comment period. The SEC's proposal on ESG disclosures for investment advisers and investment companies would apply to registered investment companies, business development companies, registered investment advisers, and "certain unregistered advisers."[4] The proposed rule and corresponding amendments are expected to foster uniformity of ESG disclosures, reducing information asymmetry at the expense of the investor, and improving comparability of ESG investments.[5] Generally, the proposal would require funds that consider ESG factors to disclose requirements regarding ESG strategies in fund prospectuses, annual reports, and adviser brochures and environmentally focused funds to disclose greenhouse gas (GHG) emissions associated with their portfolio investments.

The proposal also defines three types of ESG funds:[6]

1. **Integration funds** – Funds that integrate ESG factors alongside non-ESG factors in investment decisions would be required to describe how ESG factors are incorporated into their investment process.
2. **ESG-focused funds** – Funds for which ESG factors are a significant or main consideration would be required to provide detailed disclosure, including a standardized ESG strategy overview table.
3. **Impact funds** – A subset of ESG-focused funds that seek to achieve a particular ESG impact would be required to disclose how it measures progress on its objective.

Rule 35d-1, also known as the "Names Rule," assists with the alignment of a fund's name and its corresponding investments and risks.[7] The SEC's proposed amendment to the Names Rule would (1) require funds to invest at least 80% of their assets in a way that is aligned to the fund's name and (2) create additional disclosure requirements and recordkeeping requirements related to the fund's name.[8] In addition to potential updates mentioned above, the proposal would also address the following:[9]

- Instances where it is permissible for investment funds to abandon the 80% policy parameters and related guidelines for bringing the ratio back within policy.
- Restrictions placed on those unlisted closed-end funds and business development companies, without shares listed on a national securities exchange, preventing alterations of the 80% investment policy absent a shareholder vote.
- Transparency of the extent to which funds consider ESG factors as opposed to non-ESG factors in their investment decisions and whether the use of "ESG" or comparable language in its name would be deemed a substantial misrepresentation.
- Allowance of electronic shareholder notification in the event of adjustments to the 80% investment policy.

The Commodity Futures Trading Commission (CFTC) hosted its inaugural Voluntary Carbon Markets Convening on June 2, 2022, in Washington, DC. The meeting was intended to discuss issues related to the supply and demand for high-quality carbon offsets, including product standardization and the data necessary to support the integrity of carbon offsets' GHG emissions avoidance and reduction claims.[10] Opening remarks from Chairman Rostin Behnam focused on the agency's positioning "at the forefront of climate-related risk management" given the use of derivatives to dampen climate-related risks.[11] The agenda included four panels aimed at collectively examining key topics top of mind for the agency, including:[12]

- **Carbon offset standards and quality initiatives:** Introduction to the carbon offsets markets, carbon offsets standards, and a private-sector supply-side initiative.
- **State and federal regulatory updates:** Highlights the role of carbon offsets accepted in a domestic compliance market, provides an overview of recent regulatory initiatives that may directly or indirectly impact the markets for carbon offsets, and provides perspectives on the role of carbon offsets within a whole-of-government approach to mitigating climate change.
- **Carbon offsets trading and infrastructure:** Overview of carbon offset spot markets, exchange-listed derivatives, registry infrastructure, and OTC intermediation.
- **Market participants' recommendations for the CFTC:** Perspectives on carbon offset projects from industry and the public interest. Challenges and opportunities of trading carbon offsets and/or carbon offset derivatives; documentation issues; and recommendations for the role of the CFTC in these markets.

During the Convening, Chairman Benham discussed the establishment of the CFTC's Climate Risk Unit during the first quarter of 2021, the CFTC's overall interest in regulating growth in the voluntary carbon markets while ensuring adequate supervision, and the June 2, 2022, climate-related information request.[13] Responses to the request are expected to inform its perspective on climate-related risk. Also noted in the request is the CFTC's intent to use the responses to inform future regulation, supervisory activities, and reports.[14] The information request has a 60-day comment period and calls for broad commentary on climate-related financial risk in the derivatives and commodities markets. In addition, the information request seeks narrower responses to 34 questions spanning 10 topical areas:[15]

- Data
- Scenario analysis and stress testing
- Risk management
- Disclosure
- Product innovation
- Voluntary carbon markets
- Digital assets
- Financially vulnerable communities
- Public-private partnerships/engagement
- Capacity and coordination

According to a May 31, 2022, BIS press release, the Basel Committee on Banking Supervision (BCBS) met in late May and approved finalized principles on climate-related financial risk management with anticipated publication in June; however, at the time of this writing the principles have not been published.[16] Similar to the BCBS 2021 consultative paper, *Principles for the effective management and supervision of climate-related financial risks*,[17] the forthcoming finalized principles are expected to assist with the enhancement of supervisory practices and provide insight on climate-related risk mitigation. BCBS developed the principles in a way that allows for tailoring to better align with the risks and exposures of multiple banking systems.[18] The climate principles represent only a piece in the BCBS's comprehensive review and response to climate-related risk exposures found in the international banking system.[19] Once available, analysis of the finalized principles will be included in a future edition of this digest.

In May 2022, the International Association of Insurance Supervisors (IAIS), a voluntary membership organization of insurance supervisors from more than 200 jurisdictions and constituting 97% of the world's insurance premiums,[20] released its *Year in Review 2021* publication reflecting on its activities between January and December 2021. The IAIS set out its climate focus from 2016 through 2022 and beyond, noting how it started with setting the foundation for climate risk, embedding into supervisory practices, and expanding and building into broader efforts.

The IAIS has shown a commitment to climate change, as a key theme within its Strategic Plan, and the activity performed through 2021 is set out in the publication. The IAIS' work on climate change varies across areas including financial stability, risk assessment, developing supervisory and supporting material, and capacity building.[21] In 2021, the IAIS committed to significantly increase its focus on climate change issues. To support this commitment, the IAIS published an "*Application paper on supervision of climate-related risks in the insurance sector*," finalized in November 2021, to provide recommendations and examples of good practices for addressing climate risks.[22] The IAIS has provided industry data to emphasize the impact of climate-related risks. In September 2021, the IAIS published a global quantitative study that concluded more than 35% of insurance investments may be exposed to climate-related risks.[23] Additionally, the IAIS has partnered with other organizations (e.g., A2ii [Access to Insurance Initiative] and the Sustainable Finance Forum) to broaden climate-related risk knowledge across the industry by providing training to stakeholders demonstrating how supervisors can work with insurers to highlight climate change impact.[24] Going forward, the IAIS is focused on expanding efforts to include:

- Insurance Core Principles updates and supporting material to include climate risk more explicitly;
- Scoping and sharing best practices on climate risk scenario analysis; and

Climate data elements integrated in Global Monitoring Exercise.[25]

On April 29, 2022, the Financial Stability Board (FSB) published an interim report on supervisory and regulatory approaches to climate-related risks to provide recommendations to assist supervisory and regulatory authorities in developing their approaches to monitor, manage, and mitigate cross-sectoral and systemwide risks arising from climate change and to promote consistent approaches across sectors and jurisdictions.[26] With a cross-sector and systemwide focus on climate-related financial risks, the report complements standard-setting bodies' ongoing work on approaches to addressing climate-related financial risks for their respective sectors.

The report seeks to assist with the development of a consistent approach to assess and mitigate financial vulnerabilities arising from climate-related risks and provides recommendations under three areas:[27]

1. **Supervisory and regulatory reporting and collection of climate-related data from financial institutions:** Consistent and comparable firm disclosures, based on a global baseline climate reporting standard, provide a good starting or reference point for the future development of regular standardized regulatory reporting requirements.
2. **Systemwide supervisory and regulatory approaches to assessing climate-related risks:** Supervisory and regulatory risk assessments and policies need to better incorporate understanding of the channels through which climate-related risks to financial institutions may be transferred across sectors or borders.
3. **Early consideration of other potential macroprudential policies and tools to address systemic risks:** Microprudential tools alone may be insufficient to address the cross-sectoral, global, and systemic dimensions of climate-related risks. Macroprudential policies and tools could complement microprudential measures and trade-off considerations.

The report proposes high-level guidance to support authorities on how the use of climate scenario analysis and stress tests can be expanded to incorporate climate-driven systemic risks and by introducing other potential macroprudential policies and tools to address systemic risks that may not be addressed fully by current measures.

Takeaways

- The lack of comparable, standardized, and reliable data on climate-related financial risks has been highlighted as a significant challenge in the report. This data gap has been recognized by US regulators and industry alike, and measures to close this gap may be prioritized as a regulatory objective.
- The climate-related regulatory landscape in the United States is evolving and trying to catch up with its global counterparts. Representatives from the Federal Reserve Board, SEC, and the Treasury Department are members of the FSB and may incorporate or be influenced by the report's recommendations

Additional Deloitte US perspective on climate risks

For additional insights, please see our ongoing series on how climate risks are shaping US financial regulatory initiatives and the impact these developments may have on the financial services industry and the broader economy:

- ***Centering around sustainability in financial services firms: Navigating risks, finding opportunities***
- ***Ingraining sustainability in the next era of ESG investing***
- ***Addressing the business ramifications of climate risk on banks***
- ***Building a more sustainable insurance industry***

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Endnotes

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