CLIENT ALERT

Climate Change at the Top of the Agenda: Five Things Financial Analysts Need to Watch in 2021

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Beginning in 2021, the United States may take policy and regulatory actions that align more closely with efforts undertaken in the EU and at international institutions such as APEC on the nexus of finance, trade, and climate change. More coordinated and cooperative action may be taken to set high-level standards that will be applied commercially throughout the global economy regardless of jurisdiction. International institutions are also providing greater focus on the urgency to move the global economy towards a low-carbon trajectory and build climate resiliency.

Financial institutions and corporations should take stock to better understand what the range of new regulatory rules may be, how the rules may impact their companies and what advantages may exist, and how the domestic and international issues may evolve over time. Here are five areas that finance and trade analysts should watch for:

1. **Regulatory Actions for Investor Protections**
    - **Climate-related financial disclosures** will become more common-place. In November 2020, the U.K. Treasury issued a road map policy paper for its plan to implement mandatory Taskforce on Climate-related Financial Disclosures (TCFD)-aligned disclosures across all sectors of the U.K. economy over the next five years. The TCFD has further stressed strong support of the International Financial Reporting Standards (IFRS) Foundation's proposal to create a new global Sustainability Standards Board.
    - The European Central Bank (ECB) also published a guide for financial institutions on transparency on climate risks and the safe and prudent management of climate-related risks under the existing prudential framework. It also noted that it will ask banks to conduct self-assessments to provide a basis for a supervisory dialogue on climate-related risks.
    - In the United States, there is speculation that the Securities and Exchange Commission (SEC) may require increased disclosure of potential climate-related liabilities, as well as broader disclosure related to more general Environmental, Social, and Governance (ESG) considerations.
2. **Climate Change-inclusive Monitoring for Financial Stability**
    - According to the Financial Stability Board (FSB), 24 financial authorities around the world consider, or plan to consider, climate-related physical or transition risk as part of their financial stability monitoring. Most are focused on possible changes in asset prices and credit quality. Some are also considering implications for underwriting, legal, liability, and operational risks.
    - In September 2020, the Commodity Futures Trading Commission (CFTC) subcommittee issued a report on "Managing Climate Risk in the U.S. Financial System". The first of its kind, the report encourages financial regulators to consider the risks that climate change poses to the U.S. financial system. The report contains 53 recommendations for financial markets and regulators to address climate change, including calling for coordinated efforts between the CFTC and the SEC to undertake **climate risk stress tests**.
    - The Federal Reserve's November 2020 Financial Stability Report, stated that the Fed is evaluating and investing in ways to deepen its understanding of the full scope of implications of climate change for markets, financial

exposures, and interconnections between markets and financial institutions. It will monitor and assess the financial system for vulnerabilities related to climate change through its financial stability framework. Federal Reserve supervisors "expect banks to have systems in place that appropriately identify, measure, control, and monitor all of their material risks, which for many banks are likely to extend to climate risks."

- The Bank of England will initiate a climate-related stress test in 2021 to assess different combinations of physical and transition risks over a 30-year period. The stress tests are intended to help U.K. regulators better understand how the banking and insurance sector will be affected by three different climate scenarios and to help financial institutions improve their risk management efforts.

3. **Insurance Underwriting and Liability Risk**
   - The insurance industry is increasingly focused on climate-related factors. Different sectors of the insurance industry will have varying considerations. Property and casualty (P&C) insurers may be vulnerable to increased exposure due to increasing value of property in areas prone to physical risks and increases in severe weather events. Life insurers seek suitable returns on long-term assets in a low interest rate environment and ESG-compliant investments.
   - Regulators such as the Bank of England, European Insurance and Occupational Pensions Authority (EIOPA) are focused on the implications of climate risk on the industry. The UN Environment Programme Finance Initiative has developed principles sustainable insurance. The FSB has warned that liability risks related to climate are of particular relevance to insurance firms since some such risks can (at least in part) be transferred by means of liability protection insurance.
   - In the United States, insurance regulators are increasingly being pressed to consider physical risks associated with climate change. In response to devastating wildfires on the U.S. West Coast this year, for example, U.S. lawmaker Senator Diane Feinstein (D-California) requested that the U.S. Treasury Department's Federal Insurance Office issue a report on the impacts that increased wildfire risk is having on private insurance markets, with recommendations for ensuring that home, business, and commercial property insurance remains available and affordable.
4. **Sustainable Finance**
   - **Green Taxonomies**: The EU has established a classification system for sustainable activities in its EU Taxonomy Regulation. Other governments may seek to provide a common framework for what can be defined as environmentally sustainable. The European Commission has suggested building on its own experience to design a global regulatory framework for sustainable finance.
   - Trillions of dollars of investment are estimated to be needed to combat climate change. **Green bonds**, which support funds raised for environmentally friendly projects, are rising in popularity. According to according to Bloomberg New Energy Finance, green bonds raised US$271 billion in 2019. The U.K. plans to issue its first green bond in 2021, and Germany, France, and the Netherlands have issued similar bonds. The EU is creating a Green Bond Standard. Bloomberg reports that "Issuers from anywhere in the world will be able to cite compliance, if their plans are independently verified by an EU-accredited assessor."
5. **Trade Policy as a Tool**
   - APEC has pushed for collective climate action through its efforts to reduce tariffs to five percent or less on the 54 products in APEC's List of Environmental Goods (on products such as solar panels and wind turbines). As APEC Chair for 2021, New Zealand will make it a priority to "bring economic efficiency into the environmental response through the further liberalization of environmental goods and services." APEC will explore adding new

goods to the list of Environmental Goods and further lowering tariffs. It also plans to consider whether the original definitions agreed for environmental services are still fit for purpose.

- The World Trade Organization has also recently launched two initiatives to tackle environmental issues. The new Structured Discussions on Trade and Environmental Sustainability grouping may seek to eliminate tariff and non-tariff barriers on environmental goods and services and address fossil fuel subsidies. A separate initiative will create a dialogue on plastics pollution and facilitating more sustainable plastics trade. It could revive the Environmental Goods Agreement (EGA) negotiations and set targets for reducing trade in single-use plastics.
- Analysts suggest the Biden administration may use U.S. trade policy to combat climate change by conditioning new trade deals on a partner's climate commitments and placing tariffs or a carbon fee on high-carbon imports. The EU is also exploring carbon border adjustment mechanisms and recently pitched a new transatlantic green trade agenda that could support a wider Trade and Climate initiative at the WTO.

These developments show that regulators and policymakers across the financial spectrum are already taking action to address climate risks and have broad plans to continue to pursue actions at the national and global level to steer markets towards a low-carbon trajectory through greater transparency and incentives. These actions are likely to accelerate in the coming year as the Biden administration turns its focus towards a climate agenda and as the mantle for critical international discussions in the G-20, APEC, and the UN Framework Convention for Climate Change (UNFCCC) is taken up by countries with robust climate agendas and goals.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

Himamauli Das
C&M International Senior Advisor – Washington, D.C.
Phone: +1 202.508.8751
Email: hdas@crowell.com

Ryan MacFarlane
C&M International Director – Washington, D.C.
Phone: +1 202.624.2575
Email: rmacfarlane@crowell.com

Joshua Boswell
C&M International Director – Washington, D.C.
Phone: +1 202.508.8752
Email: jboswell@crowell.com

Shelley Su
C&M International Senior Consultant – Washington, D.C.
Phone: +1 202.688.3512
Email: ssu@crowell.com

Thomas A. Lorenzen
Partner – Washington, D.C.
Phone: +1 202.624.2789
Email: tlorenzen@crowell.com

Amanda Shafer Berman
Partner – Washington, D.C.
Phone: 202.688.3451
Email: aberman@crowell.com