State and Federal Policy on ESG Issues Creates Tensions for Financial Institutions

January 25, 2023

By: Maria Vladimirova Geltz

Corporate awareness of environmental, social and governance ("ESG") risks has grown significantly in the last decade, making ESG issues a strategic priority for many boards and executives. As a result, companies, both large and small, continue to grapple with how ESG issues affect their risk management, strategic investments, and external reporting.

In the corporate world, ESG has been used by investors as a measurement standard in evaluating whether a company is the right investment. Investors will often look at how a company addresses each of the ESG "factors" in its policies, through its investments and, if applicable, its reporting. The 'E' considers how the company impacts the environment. In particular, investors may look at how the company faces physical risks, such as asset loss due to extreme weather, and also transitional risks, such as transitioning to a new technology to support a more "green" economy. The 'S' looks at how a company manages and impacts its relationships with its employees, customers, and communities. This includes a company's positions on gender equality, diversity and inclusion, and human rights, but it can also mean how the company stores and manages customer data. Finally, the 'G' relates to how the company governs itself, both through its words and its actions. This component evaluates risk management, ethics and compliance policies, governance transparency and accountability, and diversity in key management roles, including the board and at the C-suite level.

These same ESG principles have been applied to the financial services industry, with a particular focus on the impacts of environmental issues, like climate change, have on financial institutions and the financial health and resilience of the U.S. financial system. In May 2021, President Biden issued an Executive Order on Climate-Related Financial Risk directing multiple federal agencies to review and assess climate risks posed on the U.S. financial system. This spurred federal financial regulators to focus on developing an ESG-related regulatory and supervisory framework. Since then, federal financial regulators have released statements or proposed policies to navigate the increased focus on the impact of climate change on the financial industry.

The Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC"), and the Federal Reserve Board of Governors ("Federal Reserve") each released draft high-level principles for safe and sound management of climate-related financial risks for large banks with over $100 billion in assets. In an effort to promote and maintain consistency in regulation, the principles proposed by each federal regulator are substantially similar, with a focus on the following main areas: governance; policies, procedures, and limits; strategic planning; risk management; data, risk measurement and reporting; and scenario analysis. Final rules have yet to be issued.

In addition to its proposed principles on management of climate-related financial risks, the Federal Reserve recently launched a climate scenario analysis exercise with participation from six of the nation's largest banks. The exercise is meant to test the resilience of the financial institutions under different hypothetical scenarios. This will allow the Federal Reserve to gather information on climate risk management practices of large banks and assess the ability of the institutions to identify, measure, monitor, and manage climate-related financial risks. According to the Federal Reserve, this exercise is "separate from bank stress tests…which are designed to assess whether large banks have enough capital to continue lending…during a severe recession."

Additionally, the Federal Housing Finance Agency ("FHFA") has proposed initiatives related to climate change to address the potentially significant consequences climate change can have on the U.S. housing finance system. Among its initiatives, the FHFA established an internal Climate Change and ESG Steering Committee to work with Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System on certain key areas, such as assessment of climate exposure and ESG reporting and disclosure. To that end, the FHFA added resiliency to climate risks as one of its assessment criteria in its 2022 scorecard used to evaluate Fannie Mae and Freddie Mac. The FHFA also issued a Request for Input to "seek input on opportunities to strengthen its supervision and regulation of the regulated entities' management of and reporting on physical and transitional risks that may arise from natural disasters and changes in climate patterns." The FHFA ultimately seeks to ensure that its regulated entities are not only accounting for the risks of climate change, but also ensuring that they focus on ESG issues more broadly.

Likewise, states have taken action on ESG issues as well, but with a slightly different purpose. Rather than supporting ESG issues, several states have taken the opposite approach: temper down or eliminate ESG-focused investment strategies. While these anti-ESG bills vary from state to state, two main categories of bills have emerged: one category targets financial institutions that "boycott" or seemingly discriminate against companies in certain industries, particularly in the fossil-fuel energy sector. In particular, these bills prevent the state from doing business with such financial institutions or prevent the state from investing its assets through the institutions in question. The second category of anti-ESG legislation prohibits the use of state funds for purposes of "social investment," and prohibits use of strategies that consider "social factors" in connection with investing.

For example, the Indiana General Assembly is considering legislation again this year prohibiting state investments by the Indiana public retirement system with companies that boycott energy companies. This proposed legislation is on trend with recently enacted state laws across the U.S. as state lawmakers focus on anti-ESG legislation. States like Arizona, Florida, Idaho, Kentucky, North Dakota, Oklahoma, Texas, and West Virginia have all recently adopted similar anti-ESG state laws. This trend is expected to continue throughout 2023.

As we continue to watch federal and state policy unfold on ESG issues, financial institutions, in particular, remain in the unenviable position of being forced to comply with ESG mandates issued by federal regulators, while facing the potential for punitive state laws that penalize them for doing so. For questions regarding content found in this alert, please contact **Maria M. Vladimirova,** or a member of the firm's **Financial Institutions Practice**.

Disclaimer. The contents of this article should not be construed as legal advice or a legal opinion on any specific facts or circumstances. The contents are intended for general informational purposes only, and you are urged to consult with counsel concerning your situation and specific legal questions you may have.