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SEC Rules: Impact on Lenders

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SEC's Climate Disclosure Proposal Impact on Lenders

The SEC released its climate-related disclosure requirements proposal on March 21st. The proposed rules would require public companies, including many banks, to disclose both their climate-related risks along with how they will mitigate those risks, as well as their greenhouse gas (GHG) emissions. The disclosure requirements, if adopted, would provide investors information around climate-related risks that may pose financial risks to companies and help them make investment decisions. While some companies are already disclosing similar information according to their Environmental, Social, and Governance policies, the SEC rules would make it mandatory for public companies and standardize the practice.

Proposed Disclosure Requirements

Climate-Related Risks

Public companies will need to disclose all identified climate-related risks (physical and transitional risks) that may have material impacts on the business and their consolidated financial statements, including short, medium, and long-term risks. Companies will also need to disclose how those risks may affect their business model, strategy, and outlook. The SEC rules would affect the entire business, so lenders will need to report on the climate-related risks associated with their corporate assets as well as loans. While some banks have begun to analyze climate hazards and their potential effects on their loans and assets, many have not begun to collect this data or do not understand the scope of work involved.

Physical climate-related risks refer to risks from climate change, such as flooding, fires, and sea level rise. Analysis of these risks are based on the property's historical data and regional climate data, while property-specific risks need to take into account the condition of the property itself, and whether there are any resilience measures in place. An example of a property resilience measure -- if a property is located in a potential flood zone due to sea-level rise, are the energy generators and mechanical equipment relocated in an above grade location rather than the basement?

Currently, one challenge to analyzing climate-related risks is the lack of standardization in measuring the severity of climate hazards and how potential damages are calculated. ASTM is currently developing a scale to measure climate hazards for the Standard Guide for Property Resilience Assessments, which would resolve the issue when it is published. Despite this challenge, there are reputable climate hazard data reports available that can be used to assess risks to properties. Lenders can and should start gathering climate risk data now, along with site-specific data for individual assets, which will be necessary when evaluating risks. And some lenders are doing just that. Currently, the most common practice is performing one of two "tiers" of climate risk analysis during due diligence, much like it is done for environmental due diligence: 1) assessment of the regional climate hazards in the area that a property is located, or 2) assessing the regional climate hazards *plus* a site visit to evaluate property specific risks, resilience measures already in-place, and additional resilience measures needed to mitigate those risks.

In addition to evaluating climate-related risks, public companies will also need to disclose how they plan to manage the risks, and how the processes are integrated into its overall risk management system. If the company has a adopted a transition plan, they will need to provide a description of the plan with relevant metrics and targets.

GHG Emissions, Targets, and Goals

In addition to climate-related disclosures, the proposed rules would also require companies to report on their GHG emissions for the most recent completed fiscal year. While companies with ESG policies or those that have committed to net-zero goals would already have begun collecting and reporting this data, the SEC rules would make GHG emissions reporting a standard practice. Reporting would be required for at least the first two out of three scopes of emissions, as defined by the EPA: Scope 1 consists of direct emissions from owned or controlled sources; Scope 2 includes indirect emissions from the generation of electricity, or heating and cooling that are purchased by the company. For lenders, Scopes 1 and 2 would include the emissions emitted by their owned corporate assets.

The SEC would also require reporting of Scope 3 emissions if they are material to the company, or if the company has set a GHG emissions reduction target that includes Scope 3 emissions. EPA defines Scope 3 as indirect emissions that occur within a company's value chain. For lenders, Scope 3 emissions would likely mean reporting on the emissions data of any loans and collateral properties.

If a lender has set GHG reduction goals, they would also be required to provide information about the measures they are taking to reduce emissions and their timeframe to getting to those targets.

While companies still have some time before filing even after the rules are adopted--the first compliance year for Scope 1 and Scope 2 would be for fiscal year 2023 (filed in 2024) for large accelerated filers, and Scope 3 would be due for fiscal year 2024 (filed in 2025)—those who have not reported on GHG emissions in the past should investigate the varied emissions sources they have and ensure that they are ready with the data when reporting time comes. While reporting requirements for Scope 3 emissions remain to be determined, lenders can and should begin gathering data for Scope 1 and 2 emissions.

Fortunately, lenders would not need to gather all this data themselves, since third-party consultants can help gather the data, assist with the reporting, and provide recommendations to help lower GHG emissions.

The Next Step

The SEC rules are not finalized yet, but the trend is clear. The Net Zero Asset Managers Initiative, which launched in December 2020 and currently has 128 signatories–overseeing $43 trillion in assets–is committed to supporting net zero greenhouse gas emissions by 2050 or sooner. Companies are setting ESG and property resilience goals as investors demand this information to make their investment decisions. Though lenders may not need to commit to the same goals, setting targets to address climate-related risks and developing policies and processes to mitigate those risks will be advantageous in the long-run.

Present-day investors and borrowers are scrutinizing lenders' ESG strategies to determine with whom they want to do business. Lenders at the forefront of ESG can strengthen their public trust, stay ahead of the upcoming regulatory requirements, and have significant growth opportunity. Multiple articles/interviews conducted within the last year have indicated that most lender CEOs believe their future growth will largely be determined by their ability to anticipate and navigate the shift to a low-carbon, clean technology economy.

Finally, as lenders move forward to develop an ESG policy, they should understand their current ESG baseline, have an understanding of regulatory expectations, understand that ESG risks are real and relevant and should be evaluated as part of the credit and valuation risk, and develop an ESG strategy that is integrated into the lender's overall business strategies.

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