Climate Change and U.S. Financial Regulators: Overview and Recent Actions

May 11, 2021

Under the Biden Administration, financial regulators have announced a range of new measures to address financial risks associated with climate change. The Department of the Treasury, the Securities and Exchange Commission (SEC), and the Federal Reserve have each announced new steps:

- The Treasury’s announcement covers a range of issues including public spending, macroeconomic effects, and international cooperation.
- The SEC’s addresses investor disclosure requirements relating to climate risks and the classification of funds marketed to investors as environmentally friendly.
- The Fed’s relates to lending risks for individual financial institutions and to systemic financial risks related to climate change.

This Insight provides an overview of these actions and how they interrelate.

Background: Financial Sector Climate Risks

An international standard-setting body, the Financial Stability Board, has noted that climate change can affect financial stability and asset prices either through physical risks such as more damaging storms and wildfires or through transition risks in which changes in government policies or market perceptions might lead to sudden asset price changes, such as for industries that emit greenhouse gases (GHGs). For instance, in any transition to a net-zero GHG emissions economy, fossil fuel industry assets might lose value. By some estimates, assets held by fossil fuel companies globally could drop between $250 billion and $1.2 trillion or become “stranded assets” in a possible transition away from fossil fuels.

Estimates of potential losses to the financial sector from physical risks are also relatively large. In the housing market, one paper found that, as of 2019, the government-sponsored enterprises, Fannie Mae and Freddie Mac, guaranteed $6.88 trillion in home mortgage debt without pricing flood risk into their guarantee fees—risks ultimately backstopped by the U.S. government. Almost all the U.S. flood risk that is insured is also backstopped by the U.S. government through the National Flood Insurance Program.

There is evidence that investors are already seeking to accurately price climate risks into asset prices. In the roughly $4 trillion U.S. municipal bond market, one paper concluded that counties more likely to be...
affected by climate change paid more in underwriting fees and initial bond yields when issuing long-term municipal bonds.

Recent Actions

President Biden announced on April 22, 2021, a voluntary target for the United States to achieve a 50%-52% reduction from 2005 levels in economy-wide net GHG emissions by 2030, although specifics for achieving it have not yet been released. The White House also issued an executive order on January 27, 2021, promising to expand financing internationally for projects to reduce GHG emissions or promote climate adaptation. A White House International Climate Finance Plan, released April 22, 2021, focused on ways to mobilize public and private funds internationally toward climate-friendly goals.

Treasury

The White House plan involves the Department of the Treasury working with other U.S. government agencies and multilateral development banks on international cooperation and with U.S. financial regulators to manage, and improve information on, climate-related risks. In an April 21, 2021, speech, Secretary Janet Yellen provided details on how Treasury would look at international cooperation, tax, and macroeconomic policy issues to promote climate goals.

Yellen stressed that one key issue was climate risk disclosures. Making these disclosures clearer and more standardized would enable investors to better compare risks across companies and would drive capital toward cleaner energy, Yellen noted. Clearer climate disclosures—the purview of regulators such as the SEC—could impact GHG emissions targets if they drive investors toward “clean energy” projects or if investors demand higher returns for climate risk. Disclosure efforts may be spearheaded by financial regulators but have ramifications for the broader White House plan. Some argue, however, that assessing “actionable” climate risks for investors can be challenging or misguided. Others argue disclosures alone may be insufficient to mitigate systemic risks.

Yellen announced April 19, 2021, the creation of a “climate hub” within Treasury to coordinate three areas: (1) climate transition finance, (2) climate-related economic and tax policy, and (3) climate-related financial risks. She also stated that Treasury would coordinate with the U.S. Financial Stability Oversight Council to mitigate climate risks to financial stability and improve climate risk information.

Securities and Exchange Commission

SEC Chair Gary Gensler pledged, in response to congressional questions, to continue work on enhancing climate-related disclosures. In February, 2021, Allison Herren Lee, then acting SEC chair, directed the SEC’s Division of Corporation Finance to enhance its focus on climate-related disclosure in public company filings. She said the SEC would update its 2010 guidance on disclosure of climate change risks and would assess compliance related to that guidance.

The SEC also announced in March 2021 the creation of a “Climate and ESG [Environmental, Social, and Governance] Task Force” within the SEC’s Division of Enforcement to identify misconduct related to funds branded as ESG. In recent years, funds marketed to investors as “ESG” have grown markedly, but there is no universally agreed-upon or legally binding definition of what constitutes an ESG fund. In April 2021, the SEC’s Division of Examinations warned that a review it conducted of ESG funds found a number of misleading statements regarding ESG investing processes and adherence to voluntary global ESG frameworks, among other issues.
Federal Reserve

On January 25, 2021, the Fed announced the creation of an internal Supervision Climate Committee to strengthen its “capacity to identify and assess financial risks from climate change” and “develop an appropriate program to ensure the resilience of supervised firms to climate-related financial risks.” In a March 2021, speech, Fed Governor Lael Brainard announced the creation of a Financial Stability Climate Committee at the Fed to identify, assess, and address climate-related risks to financial stability from a macro-prudential perspective. On the international front, the Fed announced in December 2020 it had formally joined the Network for Greening the Financial System, a group of over 80 central banks focused on climate-related risks that has begun developing methodologies for conducting climate stress testing. Also, the Fed is co-chairing the Basel Committee on Banking Supervision’s Task Force on Climate-Related Financial Risks.

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