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Climate-Related Financial Risk: (Net) Zeroing in on Key Private Equity Considerations under the Biden Administration's Executive Order

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On May 20, 2021, President Biden signed an Executive Order on Climate-Related Financial Risk, which outlines various initiatives to promote policies related to physical and transition risks associated with climate change and to prioritize federal investments in support of those policies. In this alert, we focus on key aspects of the order that could have implications for private equity funds and areas of consideration for asset managers as a whole.

The Executive Order addresses five broad priorities:

1. develop a government-wide strategy for mitigating climate-related financial risk;
2. encourage financial regulators to assess climate-related financial risk;
3. encourage consideration of climate-related financial risks related to life savings and pensions;
4. modernize federal lending, underwriting and procurement practices by incorporating climate-related financial risks; and
5. reduce the risk of climate change to the federal budget.[1]

Various federal entities are directed to develop strategies and prepare reports in furtherance of these goals. While the Executive Order has no immediate impact on the rules governing financial markets, it signals a shift in federal priorities that could create opportunities for private equity in the future.

Implications of the Executive Order for Private Equity

Climate-Related Financial Risk Strategy

The Executive Order calls for development of a government-wide climate risk strategy. The strategy must address the measurement, assessment, mitigation, and disclosure of climate-related financial risk to federal government programs, assets, and liabilities. The strategy also must identify financing needs associated with achieving net-zero greenhouse gas emissions for the U.S. economy by 2050 and opportunities for public and private investments to meet those financing needs. The Director of the National Economic Council and the National Climate Advisor must coordinate with the Secretary of the Treasury and the Director of the Office of Management and Budget to develop the strategy by September 17, 2021 (120 days after the date of the Executive Order).

Such a broad-based climate-risk strategy could present opportunities for private equity to target companies that can contribute to the goal of achieving net-zero greenhouse gas emissions by 2050. According to 2019 figures released by the Environmental Protection Agency, the totality of United States greenhouse gas emissions can be traced to five sectors: transportation, electricity generation, industry, commercial & residential, and agriculture.[2] These five sectors are responsible for 29%, 25%, 23%, 13% and 10% of national greenhouse gas emissions, respectively. In the industrial sector alone, the cement[3] and steel[4] industries each contribute approximately 8% to global greenhouse gas emissions.

Climate-related innovation in all five of these sectors is increasing rapidly, aided by substantial growth in private equity investment in technology companies that have developed, or are in the process of developing, carbon-neutral or less carbon-intensive alternatives to activities that are traditionally carbon-intensive. For example, numerous funds seek to invest specifically in environmental and cleantech companies with the potential to reduce greenhouse gas emissions through innovative technologies. In addition, BlackRock and Vanguard recently became signatories of the Net Zero Asset Managers Initiative, which unites asset managers around the goal of achieving net zero emissions by 2050 or sooner. These investment strategies and commitments are aligned with the goals of a federal climate-related financial strategy, and private equity funds with similar approaches should be well-positioned to take advantage of any new opportunities that arise from the Executive Order.

Potential Impact on Pension Funds

The Executive Order directs the Secretary of Labor to take several actions that could facilitate more retirement plan investments in private investment funds and other investment vehicles with strategies that promote or focus on environmental, social and governance (ESG)-related goals. The Executive Order includes a general directive to identify agency actions that could be taken under the Employee Retirement Income Security Act of 1974 (ERISA) and the Federal Employees' Retirement System Act of 1986 to protect retirement savings and pensions from the threats of climate-related financial risk. Additionally, the Executive Order directs the Secretary of Labor to consider proposing a rule, by September 2021, to suspend, revise, or rescind two ESG-related rules adopted by the Department of Labor (DOL) under the Trump administration (the "2020 rules"). The 2020 rules generally require ERISA plan fiduciaries to make plan investment and proxy voting decisions based solely on consideration of "pecuniary factors" and prohibit them from making such decisions based on non-pecuniary considerations (e.g., ESG type factors) except in very limited circumstances.[5] In part because the 2020 rules (and confusion about the 2020 rules) had a chilling effect on the appropriate integration of ESG factors in ERISA plan investment decisions, the DOL announced in March that it would not enforce the 2020 rules until further guidance is issued. Notwithstanding the DOL's non-enforcement statement, the 2020 rules have not actually been rescinded, and additional rulemaking could provide some welcome clarity on these issues.[6]

Rescinding or substantially revising the 2020 rules could mitigate confusion and fears surrounding investing based on ESG factors and goals and encourage more ERISA plan fiduciaries to incorporate ESG investments into their portfolios. However, the nature and impact of any future DOL action is unknown at this time. The Executive Order also directs the DOL to submit a report to the President on its actions in response to the Executive Order within 180 days, so we may have additional insight into the DOL's direction by November of this year.

Assessment of Climate-Related Financial Risk by Financial Regulators

The Executive Order directs the Financial Stability Oversight Council (FSOC)[7] to consider taking a number of actions, including issuing a report on any efforts by FSOC member agencies to integrate consideration of climate-related financial risk into their policies and programs. This report would discuss, among other things, the necessity of any actions to enhance climate-related disclosures by regulated entities to reduce climate-related financial risk to the financial system, and any other recommendations for mitigating such risk through new or revised regulatory standards. Although the order only directs the FSOC to consider issuing the report, we expect to see a report that addresses most, if not all, of the topics identified in the Executive Order by November 16, 2021, the deadline imposed in the order. The emphasis on climate-related disclosures is consistent with efforts already underway at the SEC to develop proposals for mandatory climate change disclosure requirements that would apply to public companies.[8]

Federal Lending, Underwriting, and Procurement

The Executive Order includes several directives related to government contracting and lending by federal agencies. It seeks recommendations for the integration of climate-related financial risk information into federal financial management and financial reporting, especially as that risk relates to federal lending programs. The order also calls for consideration of changes to federal procurement rules that would (i) require major federal suppliers to publicly disclose greenhouse gas emissions and climate-related financial risk, and (ii) give preference to suppliers with a lower “social cost” of greenhouse gas emissions. Additionally, federal agencies must integrate climate-related financial risk into their own procurement processes. With the increase in infrastructure-focused private equity funds and the expansion of investment mandates of existing private equity funds, asset managers will need to follow these potential regulatory changes in connection with the development of their investment thesis and the assessment of specific investments in the infrastructure vertical, distribution and procurement verticals and other ancillary verticals that interact with the federal government on a commercial basis.

Looking Ahead

The Executive Order does not create any immediately enforceable rules, but it does chart a course for greater emphasis on climate-related risk considerations in federal financial policy. Reports that are required or suggested by the order will shed additional light on the potential longer-term impact of this policy shift on the financial markets and regulated entities. While many of the priorities covered by the order will not affect the asset-management industry, we believe that development of a more climate-focused federal financial strategy and potential related changes to the ERISA rules could create opportunities for private equity firms that are prepared to take advantage of these shifts in policy. Proskauer will continue to track significant regulatory changes with a focus on the implications and opportunities for private equity funds, and we encourage asset managers to monitor developments in this area.

If you would like to discuss or have further questions on this client alert, please reach out to James Lee and Karen Garnett.

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[1] See White House Briefing Room Fact Sheet: President Biden Directs Agencies to Analyze and Mitigate the Risk Climate Change Poses to Homeowners and Consumers, Businesses and Workers, and the Financial System and the Federal Government Itself, May 20, 2021, available here.

[2] See United States Environmental Protection Agency, Sources of Greenhouse Gas Emissions, available here.

[3] See Chatham House Report, Making Concrete Change: Innovation in Low-carbon Cement and Concrete, June 13, 2018, available here.

[4] See McKinsey & Company, Decarbonization challenge for steel, June 3, 2020, available here.

[5] Fiduciary Duties Regarding Proxy Voting and Shareholder Rights, 85 Fed. Reg. 81658 (December 16, 2020); Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 72846 (November 13, 2020). Additional information regarding such rules is available here and here.

[6] Additional information regarding such announcement is available here.

[7] FSOC member agencies include: Department of the Treasury, Federal Reserve, Office of the Comptroller of the Currency, Consumer Financial Protection Bureau, U.S. Securities and Exchange Commission, Federal Deposit Insurance Corporation, Commodity Futures Trading Commission, Federal Housing Finance Agency, National Credit Union Administration Board, Office of Financial Research, and Federal Insurance Office.

[8] See, e.g., SEC Request for Input on Climate Change Disclosures, available here.

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