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What If Banks Had to Disclose the Climate Impact of Their Investments?

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Summary. The U.S. Securities and Exchange Commission recently proposed a new federal rule requiring all publicly traded companies to disclose climate risks and carbon emissions. This rule holds the potential to make huge progress by forcing banks to disclose which carbon-intensive projects they are financing. If passed, the rule will give bank investors greater transparency on the global climate emissions generated by their investment; once disclosed, banks will work to reduce their carbon exposure, which means new products and new terms to finance low

carbon projects — globally. People should understand the transformative effects of disclosing the carbon impacts of bank financing, if only the SEC rule can pass.

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The U.S. Securities and Exchange Commission recently proposed a new federal rule requiring all publicly traded companies to disclose climate risks and carbon emissions. It's meant to provide greater transparency to guide investor decisions. The proposed regulation is not a surprise in itself — it was broadly signaled and much anticipated. But whether the rulemaking is finalized into regulation or not, there's a transformative impact that few realize. By covering U.S. publicly traded banks, this rule would, in one giant step, cover climate emissions across a major swath of the global economy.

How Does It Work?

The proposed regulation would require public companies to report their climate emissions, which come in three standardized reporting forms. Scope 1 emissions are those generated onsite. Scope 2 emissions are those from energy that is purchased. Scope 3 emissions are generated by a company's supply chain and products in service. Some companies already disclose Scopes 1 and 2. These are the easiest to report using energy supply and utility bills. Scope 3 is hard. It requires an analysis of all greenhouse gas impacts from a company's supply inputs as well as the carbon implications for the company's products used over their lifetime. Many companies are pointing to the burden the regulation could create. At the same time, new data mining and modeling methods are being developed to help calculate Scope 3 emissions.

Following the Money

Consider the proposed rule through the lens of a bank. Scope 1 for a bank could be the boiler in the basement burning natural gas to provide heat for the building. Scope 2 could be the electricity purchased from the local utility. In addition to the supply chain, Scope 3 would be the carbon emissions that result from the bank's loans and investments, which are *the products* of a bank. These range from real estate to fossil fuels and other carbon intensive products. Let that sink in.

If U.S. public banks are required to disclose the carbon emissions of loans, they in essence cover the global economy since they loan to public and private companies, institutions, and entities across the world. This regulation would directly link financing to emissions in a way that's never been done before. The implications are broad:

- Bank investors will have greater transparency on the global climate emissions generated by their investment.
- Likewise, the public (and regulators by extension) will have a better understanding of the money fueling carbon emissions.
- And presumably once disclosed, banks will work to reduce their carbon exposure, which means new products and new terms to finance low carbon projects — globally. Presumably, an asset's carbon profile will become as relevant as its credit risk to guide bank terms.

Losers and Winners

Fossil fuel exploration and extraction is capital intensive requiring bank financing. The carbon impact of that financing would now have to be reported by the proposed rule, even if the fossil fuel company doesn't report itself. Money may not flow as easily to the fossil fuel sector, or at least not at today's rates and terms.

On the flip side, more money could flow to renewable energy development. Another beneficiary would be buildings — the largest investment asset class in the world and one of the largest users of bank financing, especially for mortgages. In large cities like New York, buildings represent 70% of carbon emissions. The SEC regulations would bring bank interests closer to building carbon emissions, hopefully to finance more building energy retrofits to reduce the carbon profile of cities. This would not only save carbon, it would prevent the release of air pollutants when fossil fuels are burned, improving public health — especially respiratory health most relevant in the Covid-19 crisis.

Financing “Dirty” Projects

Where will carbon intensive projects secure financing? Private sources of capital may step in to fill the void, such as private equity firms. However, this may not completely escape the intent of the SEC rule since every company’s Scope 3 emission is another company’s Scope 1 emission. In this scenario, a carbon intensive project may secure private capital, but may still have to report its carbon impact to customers under their Scope 3 reporting. It’s more likely that banks could still lend to these projects, just at different terms. “Dirty” projects may have to pay higher costs — a “brown” premium of sorts while “green” discounts are provided to lower carbon entities. This would also start to price carbon in a new way.

Just a Proposal?

The SEC proposal is just that — a proposal to which the public can comment and the government will decide to make a final regulation, or not. Many industries are opposing the measure, and members of Congress are calling for hearings on the SEC approach. Despite that opposition, those in government that want to advance the climate agenda will quickly see the widespread benefit of the SEC proposal. It’s important to note that the SEC has the ball, and the authority to act without Congress. The Washington give-and-take process will play itself out. But, the more people understand the transformative effects of disclosing the carbon impacts of bank financing, the more interest will build. Progressive banks may voluntarily decide to disclose these emissions whether there's a regulation or not, and due to the highly competitive industry nature, this could prompt more banks to follow.

Ironically, where governments have fallen short to slow global carbon emissions, a proposal to require U.S. private sector disclosure could have the greatest impact in fighting climate change — and one few realize yet.

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