American Bankers Association
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June 17, 2022

The Honorable Gary Gensler
Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

RE: File Number S7-10-22 -- Proposed Rule: *The Enhancement and Standardization of Climate-Related Disclosures for Investors*

Via email: rule-comments@sec.gov

Dear Chairman Gensler:

The American Bankers Association[1] appreciates this opportunity to respond to the Proposed Rule: *The Enhancement and Standardization of Climate-Related Disclosures for Investors* (Proposal),[2] which would be applicable to all public companies. The Proposal responds to the call for increased disclosures within the *Report on Climate-Related Financial Risk*, published in 2021 by the Financial Stability Oversight Council (FSOC)[3] and recommends significant and extensive changes to how companies disclose current and future climate risks, how they are managed, and where they will be reported. The Proposal also requires the non-financial measurement, disclosure, and certain auditing of the greenhouse gases (GHGs) emitted, not only directly by a company, but also by a company's business partners and through use and disposal of its products.

As currently proposed, these requirements go far beyond the SEC's mandate to protect investors. ABA respectfully urges the Commission to address the serious concerns we note in this letter. New standards for climate-related disclosures and accounting must conform to the long-held definition of materiality and also be scalable to the size and complexity of the registrant. A final rule must limit disclosure requirements for Scope 3 emissions to those explicitly included in a registrant's material, publicly announced climate-related goals and sufficient safe harbors and transition time must be provided, given the nascent state of climate-related financial risk

[1] The American Bankers Association is the voice of the nation's $24.0 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $19.9 trillion in deposits and extend nearly $11.4 trillion in loans.

[2] https://www.sec.gov/news/press-release/2022-46

[3] FSOC brings together the expertise of federal financial regulators, state regulators, and an independent insurance expert appointed by the President. It is charged with identifying risks to the financial stability of the United States; promoting market discipline; and responding to emerging risks to the stability of the United States' financial system.

management. We believe the significance of these recommendations will likely require withdrawal and reproposal of the rule.

ABA acknowledges that certain investors may have an interest in understanding the existing and potential climate-related financial risks of registered companies and that the SEC's mandate requires disclosure of all material risks. However, the Proposal goes far beyond that mandate and requires registrants to disclose all climate-related information—essentially declaring climate risk to be material whether of direct interest to investors or not. In doing so, this disclosure regime may inappropriately reallocate capital and investment away from emission-producing sectors of the economy. Efforts to reduce greenhouse gas emissions, as desirable as they may be to address climate change, must be effectuated by Congress, and not mandated or otherwise directed through a regulatory agency without an explicit environmental mandate.

ABA believes a useful and operational climate disclosure framework can be achieved. However, the Commission needs to revisit this effort and apply the following principles and recommendations detailed in the attached appendices.

The SEC must apply the "reasonable investor" standard of materiality to climate-related disclosure requirements.

Climate-related disclosure requirements should be limited to companies where there is a substantial likelihood that a reasonable investor would consider climate-related factors important when determining whether to buy or sell the company's securities, or how to vote on company proposals. Adhering to this long-held understanding of materiality – the backbone of accounting, financial reporting, and risk management – would align with the Commission's approach to disclosure in other areas and ameliorate concern that this Proposal is elevating political considerations over investor protection.

Although climate change is an important issue to many, climate-related factors are not the foremost consideration of most investors and most companies. Yet the Proposal would require *all public companies* to disclose and audit their Scope 1 and 2 emissions.[4] Additionally, the Proposal requires disaggregating, on a line-by-line basis, specific climate-related impacts within the financial statements at a dramatically low materiality threshold of one percent of each line item, based on an absolute value basis. Regardless of the industry or the importance of GHGs to a company's short, medium, or long-term performance, the Commission has deemed these material metrics and amounts. Putting aside for the moment the very real question of whether the

[4] The Commission proposes disclosure of GHGs emitted by registrants, disaggregated by seven different GHG types, and reported in accordance with "scopes" defined by the *Greenhouse Gas Protocol Corporate Accounting and Reporting Standard* (GHG Protocol). Scope 1 represents gases directly emitted by the company; Scope 2 represents indirect emissions (those normally purchased from a local energy company), and Scope 3 emissions are other indirect GHGs emitted through value chain partners of the registrant. This disclosure will be accompanied by carbon-equivalent intensity metrics (GHGs per revenue, for example) for each company.

Commission has the authority to require such extensive information reporting,[5] such a regime is neither cost effective nor necessary to inform investor decisions.

Such an expansive directive can have serious unintended consequences to accounting and auditing practices across all entities, public and private and it establishes a troubling precedent for future tracking of other non-financial issues. Registrants will need to engineer complex financial and non-financial accounting systems to be able to address a myriad of future stakeholder concerns, and investors will need to sort through the fog of data that will often be of little decision-usefulness. This is bound to make registrants less competitive with companies not subject to such stringent requirements, discourage companies from utilizing the public markets, and even discourage small businesses from partnering with banks and other businesses who may be forced to require GHG emission data from their customers.

We strongly urge the Commission to apply the Supreme Court's well established "reasonable investor" standard in connection with climate-related disclosures and to tailor the proposed rule to apply only in circumstances where the underlying business of the company has a direct and material connection to GHG emissions, or where a company has made a specific climate-related pledge or goal to investors. Additionally, we recommend the elimination of the required Regulation S-X disclosures. Any disclosure of material climate-related financial impacts should be located in Management's Discussion and Analysis or another section of Regulation S-K, where the traditional concept of materiality is applied outside the context of audited financial statements.

To the extent climate-related disclosures are necessary to inform investor decisions, they must be scalable to the size and complexity of the registrant, as well as the materiality of climate-related risks to its business.

As highly regulated financial institutions, our members are critical providers of liquidity within an economy that must support individuals, companies, and communities in the short-, immediate-, and long-term. Banks play a key role in financing economic transition to avoid the harm that will come to communities if financing of businesses and industries essential to local economies is abruptly curtailed. Within the evolving discipline of climate-related financial risk management, all banks are engaged in analysis of financial impacts of potential climate risks, whether through sophisticated modeling or more informal review of climate risks within their routine market assessments and daily underwriting processes.[6] Those efforts are appropriately focused on prudential concerns. In all cases, banks address the risks they face under close supervision and examination by their prudential regulators.

[5] https://www.sec.gov/news/statement/peirce-climate-disclosure-20220321

[6] See Federal Reserve Bank of New York Staff Report "How Bad are Weather Disasters for Banks?" January 2022, which notes "...We find that FEMA disasters over the last quarter century had insignificant or small effects on U.S. banks' performance. This stability seems endogenous...Local banks tend to avoid mortgage lending where floods are more common than official flood maps would predict, suggesting that local knowledge may also mitigate disaster impacts." https://www newyorkfed.org/medialibrary/media/research/staff_reports/sr990.pdf

The U.S. banking regulators have proposed climate-risk management principles only for institutions with greater than $100 billion in assets. As proposed, the many SEC registrant-banks under this threshold[7] may need to implement climate risk management and governance processes currently expected only of the largest banks. Moreover, requirements in the Proposal go further than the principles set forth or proposed by the banking regulators who supervise for safety and soundness. The proposed rules are far more prescriptive in relation to governance and risk management and more extensive in relation to disclosure of scenario analysis results.[8]

While scalability – tailoring processes to the size and complexity of the institution – has been a hallmark principle within both the regulated financial services industry and past work of the Commission,[9] the Proposal's highly prescriptive disclosure requirements mandate climate-risk processes that most small and mid-sized registrants will be unable to implement in a cost-effective manner. In fact, they will be difficult for all companies to comply with, often also requiring proprietary or otherwise confidential information. For example, the Proposal implies that all registrants will be expected to identify and retain individuals with climate risk expertise on both the Board of Directors and among management, to maintain detailed governance protocols and other internal processes, such as scenario analysis and other modeling, and to disclose specific reliance on third-party consultants and data. In addition to the requirement to separately report climate impacts in the financial statements at the low (1%) line-item level, it even requires companies to identify physical climate risks down to the Zip Code level and disclose detailed assumptions and results of modeling performed for risk management purposes. Companies of all sizes – small, medium, and large – will be required to re-code their systems on a property-by-property and transaction-by-transaction level.

The dramatically high costs of compliance with this disclosure regime will certainly outweigh the incremental benefits to market participants and other stakeholders. This could undermine the Commission's public company mandate[10] by incentivizing companies to avoid the public markets while leaving stakeholders with little additional decision-useful information. Within the regulated banking industry, climate-related modeling is in very early stages, calling into question the usefulness of any such assumptions and results. Further, the costs of compliance could overwhelm many community banks and result in an industry split between very large public

[7] Under the SEC's classification system that is based on revenues and float, community banks with approximately $3 to $5 billion in assets may often qualify as "smaller reporting companies," though even smaller banks often do not.

[8] Office of the Comptroller of the Currency (https://www.occ.gov/news-issuances/news-releases/2021/nr-occ-2021-138a.pdf) and the Federal Deposit Insurance Corporation (https://www fdic.gov/news/board-matters/2022/2022-03-29-notational-fr.pdf.)

[9] For example, responding to the issuance of the Current Expected Credit Loss accounting standard, SEC Staff Accounting Bulletin No. 119 notes that "Registrants may utilize a wide range of policies, procedures, and control systems in their allowance for credit losses processes, and these policies, procedures, and systems are tailored to the size and complexity of the registrant and its loan portfolio."

[10] SEC's three-part mission is to 1) Protect investors, 2) Maintain fair, orderly, and efficient markets, and 3) Facilitate capital formation.

companies and mostly small privately-held institutions. This would be a bad result not only for the industry, but also for the U.S. economy. A vibrant economy requires banks of all sizes and business models.

We urge the Commission to reconsider its approach in favor of one that is principles-based and scalable, based on a variety of factors, including the size of the entity, where it does business, the industry it is in, how its products or services fit into its value chains, and the climate risks it faces. Only with this flexibility will new, prospective, and existing registrants be able to comply without significantly impairing their ability to compete in the marketplace.

Scope 3 financed emissions disclosure should be limited to publicly announced climate-related targets.

Under the current proposal, banks that do not qualify as a "smaller reporting company" will be required to report Scope 3 GHGs if material, or if the company has publicly made an emissions target related to Scope 3 GHGs. Under the Greenhouse Gas Protocol, financial institutions subject to Scope 3 reporting are required to measure and accumulate Scope 3 "financed emissions" – those GHGs of the borrowers in their lending portfolios.

Financed emissions are often poor and confusing indicators of transition risk due to unavoidable variances in data availability and methodology, as well as inherent differences in risk profiles to other Scope 3 emissions and between financial products. As a result, reported estimates will be neither comparable nor consistent across registrants, and estimates across entire portfolios (and even some subsets) will be of little, if any, decision-usefulness to investors. This is especially true for investors in community banks, as they have shown very little interest to date in specific emissions estimates. The high costs of compliance will dramatically outweigh any benefit for them. Consequently, Scope 3 financed emissions disclosures should be limited to metrics for which a registrant has identified a particular target. This will support investor evaluation of the company's progress toward that stated goal.

ABA also observes that a requirement to disclose financed emissions would mean that small and privately held businesses would need to measure and report their emissions to their publicly held lender, which in turn would include those emissions in their Scope 3 reporting. The complexity of Scope 3 reporting will not only discourage growing companies from accessing the public markets, but a financed emission requirement may also discourage small businesses from banking with publicly held banks. For that matter, loan origination and other systems at privately held banks are likely to need significant revision if their loans are to conform to secondary market expectations such as those that are required by Fannie Mae and Freddie Mac, as those entities will likely change their requirements to comply with new disclosures. Such impacts are emblematic of the far-reaching consequences of the proposal, as it will result in further compliance costs even for non-public companies if they do business with – or plan to do business with - entities covered by the new requirements. To expand upon the example cited above, even privately held banks that hold loans in portfolio are likely to change their underwriting to capture new loan level information merely because they may elect to sell to Fannie Mae and Freddie Mac in the future.

The high costs of compliance and uncertain usefulness of GHG emissions estimates is likely to have other significant unintended consequences. The Proposal suggests that the SEC's goal is to use the reporting of emissions to discourage lending as a way to allocate capital away from certain industries. Utilizing regulation to shape access to capital in this way is wholly inappropriate and is not within the SEC's authority. It is the job of elected members of Congress to decide whether to regulate GHG emissions in the U.S. The SEC should not seek to regulate GHG emissions via a disclosure rule that could effectively cut off access to financing for certain industries or segments of the economy.

More extensive safe harbors and longer transition periods are needed to recognize the nascent state of climate-related financial risk management.

Even if the Commission adopts our recommendations related to materiality, scalability, and financed emissions, a workable rule must recognize the realities of the nascent state of climate-related financial risk management and the operational challenges presented if climate-related financial risk disclosures are included within Regulation S-K:

- Financial regulators worldwide acknowledge significant gaps in climate risk-related data, calling into question the reliability of any modeling, scenario analysis, or other forecasting of climate risk until such tools and methodologies are more mature.

- A significant portion of bank investment securities are issued by municipal entities, governmental agencies, and government sponsored entities. The proposed rule would likely require granular loan-by-loan data from these organizations that is not available today. Such information may change underwriting and servicing processes, which would significantly increase the implementation timeframe. Moreover, considering that data needs may change over time as more is learned about climate risk, many of these entities may be unable to supply needed information in a timely manner.

- The number of experienced personnel to oversee, execute, or otherwise be considered an "expert" in climate-related financial risk management is likely to be extremely low. The number of auditing personnel that would be qualified to perform the required assessments of greenhouse gas metrics and related internal control processes will likewise be minimal for several years.

- Accurate ongoing estimates of Scope 3 emissions for many companies will be unavailable until one to two years after a reporting period even after such reporting systems (which are largely unavailable today) are mature.

- It will likely take years before sufficient internal control reliance can be obtained on the third-party databases that the Commission appears to expect to be used for emission factors. Processes to maintain such reliance, as well as for companies to assess the relevance of the information to their individual operations, will be a significant ongoing cost.

- Current guidance relating to financed emissions was developed primarily to assist internal management in addressing its climate footprint and was not designed for strict use of the external stakeholders the SEC is targeting. As a result, they are significantly limited in scope, may not conform to current financial reporting standards, and are highly reliant on data from value chain partners that will be greater than a year old. Thus, the resulting information will likely not be decision-useful for investors. Comprehensive standards could take several years to finalize and operationalize, as new and detailed accounting systems will be needed.

Considering these facts, in order to encourage honest discussion of climate risks, the safe harbor that currently exists for forward-looking statements[11] must be significantly enhanced beyond the proposed inclusion of Scope 3 GHG measurements. A safe harbor should apply to virtually all climate-risk statements, in addition to the one proposed to address only Scope 3 emissions. It should cover not only statements made, but also acknowledge that the stringent internal control environments that normally surround SEC-based reporting may not necessarily apply. Without an expanded safe harbor, candid conversation will not occur, and boilerplate language will be the norm. An additional safe harbor must also be granted to those who are identified as having climate expertise, similar to the safe harbor in place for the "Financial Expert" within audit committees, in compliance with the Sarbanes-Oxley Act.

Further, additional transition time will be needed if a Final Rule is made effective. We note that many banks that are SEC registrants have yet to adopt the CECL accounting standard for credit loss measurement, and their 2023 adoption will be more than six years after the 2016 issuance by FASB. Considering that CECL addresses the primary business of banks (and so, much of the related information and processes should be relevant to them), implementing a new climate-related disclosure rule will likely take much longer than the Commission anticipates. ABA believes that at least an additional two years will be necessary, and the Commission should be prepared to extend the compliance date if during the transition period questions and challenges arise that call for an extension.

ABA reiterates that it supports the efforts of the Commission to provide investors with decision-useful information related to climate risk. However, the Proposal is inconsistent with the foundational materiality concept and its detailed requirements are likely to add dramatic and significant costs to registrants and even many private companies, often without a significant improvement in decision-usefulness for investors. In other words, the Proposal emphasizes process – requiring costly disclosures to discourage lending to certain segments of the economy – over actionable, decision useful information.

[11] The safe harbor is pursuant to the Private Securities Litigation Reform Act.

The attached appendices include analyses and discussion related to the key issues noted above, as well as various other technical observations and practical recommendations. Please feel free to contact me (██████████████████) if you would like to discuss this further.

Sincerely,

Michael L. Gullette

APPENDIX A: The Traditional Meaning of Materiality Must be Maintained

The Commission's redefinition of materiality will lead to information not decision-useful and to unintended consequences.

The long-held understanding of materiality is the backbone of the public company framework for accounting and financial reporting and risk management: information is disclosed to investors only if management considers it material. Information that is not material may often obfuscate actual results and confuse investors. This Supreme Court-based principle considers information material "if there is a substantial likelihood that a reasonable investor would consider it important when determining whether to buy or sell securities or how to vote."

The Commission proposes two requirements that significantly changes this notion. First, the Proposal generally requires all financial statement line items under Regulation S-X to be disaggregated by climate-related impacts, based on a Commission-defined materiality level. The proposed 1% threshold is extremely low, particularly when considering that it is calculated as an aggregate of the absolute value of even less material impacts, and is not in line with traditional levels of financial statement materiality.[12] Second, the Proposal deems that the non-financial metric of estimated greenhouse gases emitted by a registrant, as well as its business partners and consumers of its products, are automatically considered material for most companies and, therefore, must be disclosed and subject to varying levels of assurance.

Both requirements will result in disclosures that lack decision-usefulness for most companies. Together, however, these directives can have serious unintended consequences to accounting and auditing practices across all entities, public and private. For practical purposes, they open the door to costly future governance, tracking, and reporting of other subjectively determined non-financial issues that will likely arise within the contemporary ESG environment.[13] Moreover, due to the Scope 3 "financed emissions" requirement, efforts to collect such non-financial information across financial institution lending and investment portfolios effectively requires additional processes at privately owned businesses, which normally have no obligation to provide such information. Further, this will affect privately owned banks, who often originate loans that are sold on the secondary markets (such as to GSEs). It is difficult to justify the legality of requiring emissions levels for bank borrowers, especially if such information will normally have little to no significance to the ultimate collectability of a loan.

[12] A detailed discussion of the proposed changes to financial statement presentation aspect of the Proposal is included in Appendix B.

[13] ABA recognizes that companies already report financial impacts of specific events and other circumstances to investors when they are material. However, such efforts are normally executed on an exception-basis and not on the ongoing basis that the Proposal foresees.

Materiality is disregarded in requiring audited Scope 1 and 2 emissions estimates.

The Proposal for all companies to disclose Scopes 1 and 2 greenhouse gas emissions is consistent with the TCFD recommendation that acknowledges that such disclosure should be made "independent of a materiality assessment."[14] In other words, merely to reflect the TCFD recommendation, the Commission appears to disregard the long-standing practice related to materiality.[15] The Commission also goes further by requiring Scope 1 and 2 emissions to be audited, in-substance promulgating that such metrics are now material to each company.

In reality, the relevance and materiality of Scopes 1 and 2 emissions amounts will differ significantly, based on the size of the company,[16] the industry in which it operates,[17] and where in the value chain its products sit. As a result, it will likely be very difficult to meaningfully compare any climate-related risk and performance implied through Scope 1 and 2 GHGs between companies beyond what could already be accomplished through the characteristics (size, industry, etc.) just described. Comparing any GHG-related metrics between companies will likely confuse investors more than add value to their analysis. In other words, Scope 1 and 2 amounts will largely provide no decision-usefulness to investors beyond the information that is provided elsewhere in the filing.

For many companies across the economy, Scope 1 and 2 emissions are immaterial to their operations and to their stakeholders. With that in mind, while the TCFD focuses specific disclosure guidance only among the four industries outside the financial sector that are most closely associated with the major economic activities that emit or sequester greenhouse gases (Energy, Transportation, Materials and Buildings, and Agriculture, Food, and Forest Products), the Commission proposes that all companies must disclose Scope 1 and 2 emissions. In essence, the Commission is redefining materiality for the rest of these companies, which will have to bear the burden of producing and auditing such information that is normally not helpful to investors. While many companies will feel that the lack of relevance of emissions to their operations will minimize the costs of complying with the proposed rule, the opposite may be true.

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[14] See "Implementing the Recommendations of the Task Force on Climate-related Financial Disclosures," October 2021, page 21.

[15] ABA notes that the process to review and approve the 2021 TCFD recommendations was only 45 days long, hardly a sufficient time period for stakeholders (many of which are relatively new to the climate risk discipline) to assess the practical realities of many aspects of the TCFD report.

[16] This recommendation was new to TCFD in 2021. The 2017 TCFD recommendations had a general reporting threshold of $1 billion in annual revenue for those companies that did not include climate-related information in their financial filings. This scope intended to cover organizations responsible for over 90 percent of Scope 1 and 2 emissions in the industries represented by the four non-financial groups noted below.

[17] See TCFD's "Guidance on Metrics, Targets, and Transition Plans." Appendix 1: "Further Information on Select Cross-Industry, Climate-related Metric Categories" illustrates how the relationship between Scope 1 and Scope 2/3 emissions differs between key industries. ABA believes actual estimates from registrants will likely not be significantly different, thereby putting into question the additional value of disclosed measurements of Scope 1, 2, and 3 will be for stakeholders.

If Scope 1 and 2 GHGs are required, full-scale GHG accounting systems are necessary.

It is easy to underestimate the costs of measuring Scope 1 and 2 emissions, as many believe they represent two numbers (though disaggregated into seven specific types of gas). Practically speaking, however, the measurement of GHGs will require an effective accounting system that enables company management to track not only gasses emitted during the year, but also the causes for year-to-year changes in such emissions. By requiring these amounts to be audited, the Commission is mandating that all estimates of Scope 1 and 2 are material and of vital interest to investors.

If investors are truly interested in GHG levels, companies will need to implement systems to account for those changes. For example, whether or not Scope 1 and 2 emissions are significant to their operations, companies will likely need to reasonably explain whether increases or decreases in reported levels are due to:

- Business growth (or decline), which can involve changes in production (inventory) and in sales,
- Changes in materials used or in energy sources of specific processes,
- Changes in processes previously outsourced or supplied,
- Changes due to business combinations and other restructuring.

These changes will also likely need to be disaggregated by reporting segment and by whether such gases are emitted as part of the core business operations or as part of administrative overhead. In other words, separate disclosure and auditing of these measurements will require the same attention as that of the rest of the financial report.

Further discussion will also be needed by auditors to define quantitative materiality levels within Scope 1 and 2 assurance engagements. In other words, assessing whether such reported emissions are "free of material error" will be challenging. Normally, non-financial metrics can be readily converted to financial estimates. This is not so for GHGs. Considering that such audit reports have never been subject to significant market reactions or other accountability, this process could take a long time. Systems to track Scope 1 and 2 GHGs on an ongoing basis will require far more than a spreadsheet. Full-scale accounting systems will be needed.[18]

Small and privately held businesses will be hit the hardest.

As just noted, a requirement for Scope 1 and 2 emissions to be disclosed and audited means that they are deemed material to all companies. This will undoubtedly affect small businesses as well as privately held businesses, which will often need to supply such information to their publicly

[18] See Harvard Business Review article by Karthik Ramanna and Robert Kaplan "Accounting for Climate Change," which also emphasizes the point and proposes a system to present such measurements. https://hbr.org/2021/11/accounting-for-climate-change

held banks in their estimates of Scope 3 financed emissions.[19] The Commission should not assume that such businesses can easily track such emissions, much less have them audited in a cost-effective manner.

This is very concerning to ABA members. This will not only discourage growing companies from accessing the public markets, but may also discourage small businesses from banking with publicly-held banks, many of which are attempting to increase their lending to minority- and woman-owned small businesses. Such businesses are least able to implement and maintain such systems. As publicly held banks may then also need relevant and updated borrower information for their Scope 3 financed emissions estimates, the time and costs to these borrowers will detract from their strategic objectives.

<u>Recommendation</u>

The traditional concept of materiality must be retained and applied to all aspects of the Proposal, including financial statement presentation of climate impacts, as well as reporting of any of the scopes of greenhouse gas emission estimates. While the measurements themselves may not often be material to their operations, the costs will be and will normally not result in decision-useful information for investors. Along with the other prescriptive and onerous requirements introduced in this Proposal, this also can discourage smaller businesses from listing and may possibly even discourage those businesses with doing their business with registrants. This cannot be an intended consequence of the Commission.

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[19] We understand that Scope 3 estimates may currently be independently performed through references to emissions factors available in certain public databases. However, the significant internal controls environment assumed in Regulation S-K over the completeness, accuracy, timeliness, reliability, and relevance of such data (further discussed in APPENDIX E related to financed emissions) will likely require periodic updating with borrowers. Now that materiality is being redefined to significantly low levels (further discussed in APPENDIX B related to financial statement materiality), the level of borrower updating could be substantial.

APPENDIX B: Unprecedented Change to Financial Statements under Regulation S-X will be Unworkable, Confusing to Investors

The Proposal requires registrants to disaggregate climate-related impacts and expenditures within each line item presented in the financial statements and also detailed between climate-related events and transition activities. The Proposal also requires discussion related to how climate factors affected the assumptions and estimates the company made within the financial statements. These disclosures are further prescribed using a materiality threshold of one percent of the respective line item, calculated on an absolute value basis (additions and reductions in expense, for example, would be added to one another and not netted against each other).

ABA supports efforts to provide investors with decision-useful climate-related information. The proposed change, however, presents several significant challenges to both preparers and users of financial statements and by doing so creates a precedent to the evaluation of materiality that may lead to serious unintended consequences. If adopted in its current form, large sums of granular information that are not decision-useful will normally be provided to investors, dramatically detailed revisions and testing of corporate accounting systems will be needed, and stakeholders will continue to question the level of disclosure required for both financial and non-financial metrics.

Estimating climate-related impacts in the banking industry is highly complex.

U.S. GAAP already requires registrants to consider climate risk if it is directly impactful to the measurement of the corresponding asset or liability, including when evaluating the potential for asset impairment or contingent losses, with the resulting impact incorporated into the amounts actually recognized in the financial statements. In practice, the specific climate risk is not normally tracked or measured separately from other risks. The proposed rules would require such tracking and then go well beyond by effectively requiring the registrant to estimate what reported amounts *would have been* as a result of physical or transition risks.

For example, assume the registrant is considering lending to three companies and ultimately chooses the company that meets the registrant's sustainability goals (i.e., the other two did not). In this case, the proposed rule appears to suggest that the registrant must quantify how the two alternative loans would have performed and report these results in the financial line items that would not been otherwise recognized in the financial statements. The complexity quickly compounds as the registrant continues to make lending decisions and attempts to assess and model the potential for credit losses based on the alternative underwriting strategies. The incremental effort would likely be exponentially significant in these situations, particularly given the precision level contemplated (i.e., 1% of a given line item). The costly increase in financial reporting processes and systems will provide information arguably of little decision-usefulness for users.

A dramatically small materiality threshold will yield amounts that are not decision-useful.

In addition to the operational and reporting complexity that the proposal brings, certain activities and expenditures may not have significant impact on the climate risks and opportunities of a registrant, nor are a significant part of the registrant's respective business strategies, but they could require reporting to investors under the 1% materiality threshold for each line item. This bright-line percentage applied on a line item (and absolute value) basis directly conflicts with the traditional Supreme Court-based principle that "a matter is material if there is a substantial likelihood that a reasonable investor would consider it important when determining whether to buy or sell securities or how to vote."

Examples of such activities include direct participation in government-sponsored lending and investment programs as well as indirect participation through lending to businesses and consumers that participate. For example, investments in solar and wind power partnerships that are structured to provide corporate income tax credits will likely require line-item disclosure at the many banks that commonly participate in these and other social welfare programs. Customary commercial real estate lending may also necessitate disclosure in communities with green building mandates. In these and in many other cases, it will be questionable as to the decision-usefulness of such information for investors, as the related transactions will often be part of the routine business of the bank.

Understanding that climate risk is an important and complex issue currently facing investors, ABA believes the proposed materiality threshold contradicts the traditional principle noted above (as well as to how the concept is applied to the disclosure of greenhouse gas emissions, as previously discussed in Appendix A). The proposed threshold, therefore, sets a precedent that may require companies to design and implement costly systems capable of tracking any number of issues of contemporaneous prominence on a detailed level.[20]

ABA emphasizes that merely increasing the 1% threshold level does not resolve these concerns, as companies cannot normally foresee what results will be on a line item-by-line-item basis. As a result, the internal controls required to track such events and impacts, and the auditing to attest to them, will likely slow accounting and reporting processes to a snail's pace in order to provide information that is often of questionable usefulness.

[20] While climate is currently the top issue of environmental concern in the U.S., it is reasonable that other issues, such as biodiversity, ecosystems, pollution, recycling, and water protection could require attention from certain investors. Non-environmental activities with, and investment in, certain kinds of companies (such as those noted today who do business in Russia) or specific social causes may also garner detailed stakeholder attention.

Other examples require onerous judgment.

The Commission must rethink whether such information can be provided without onerous and judgmental processes. In addition to the illustration above, significant challenges companies will face in many foreseeable situations include:

a. Assessing whether events or activities are truly climate-related.
Normal societal trends (for example, of increased remote work and online retail shopping), geopolitical events, and standard market-related trends (e.g., economic cycles) can have significant impacts (both short- and long-term) on individual communities and borrowers. These factors can often, in part or in whole, be considered climate-related by many. While bankers normally assess such factors in pricing and in estimating credit losses and other contingencies, requiring a further and documented analysis to report on climate-related activity necessitates new data on virtually a transaction-by-transaction basis. An example would be a fair value estimate for investments that appears to require a disaggregation of any changes for climate-related factors. The subjectivity of such assessments will likely provide little consistency and comparability to investors and may obfuscate how management comprehensively manages the various risks it faces.

b. Assessing whether events or activities are climate event-related or transition-related.

   Policies and other actions that cause climate-related transition risk often are taken in response to specific climate events and conditions. A recent study released by staff at the Federal Reserve Bank of New York[21] indicates that climate-related events generally provide a net benefit to banks over time, due to the increased subsequent investment in the affected region. While cautioning that this trend may not continue in the future, conclusions of the study beg the questions of how such subsequent investment, which can span several years, should be evaluated under the Proposal.

In each of these situations, new and granular information may be needed from business partners and other stakeholders. For example, additional loan level information may need to be supplied by government-sponsored enterprises and agencies to support estimates of credit losses, credit spreads, and servicing rights that are attributable to climate events and transition trends.

<u>Recommendation</u>

ABA urges the Commission to either remove the line-item financial reporting requirement from Regulation S-X (the financial statements) or relocate it to Regulation S-K, while affirming the current materiality guidance. Using the above instances as examples of clarifications that may be needed to convey the Commission's general disclosure expectations, companies will be set to be responsive to investor needs by providing material and decision-useful information that is reflective of management's view.

[21] https://www.newyorkfed.org/research/staff_reports/sr990 html

APPENDIX C: Prescriptive Requirements are Unscalable and Unreasonable

Only large companies are able to comply with the prescriptive governance disclosures.

The proposed disclosure requirements related to a company's governance over and management of climate risk are so detailed, the Commission implies expectations of processes and personnel that are not only overly cumbersome, but they are also unrealistic for the vast majority of companies. For example, the Proposal requires identifying individuals on both the Board of Directors and among management that have expertise in climate risk, including "fully describing" the expertise of these individuals. The Proposal then goes further, requiring descriptions of detailed processes, such as how boards are informed of and consider climate risks, their reliance on third-party consultants, and even how frequently certain committees meet. Identification of physical climate risks is even required at the Zip Code level.

As disclosure in such detail is unnecessary over any other part of a company's business, such requirements will put into question how directors and management prioritize the *financial* objectives of their companies. Such disclosure, then, is not decision-useful for investors. Additionally, the prescriptive nature of these disclosures implies that there is a generally accepted specific way to manage climate risk (and climate-related financial risk) that is operational only by the largest companies. In this respect, ABA is concerned the Commission is not coordinating with its fellow members of the Financial Stability Oversight Council (FSOC) relating to governance and management expectations. The Office of the Comptroller of the Currency, for example, recently released the draft "Principles for Climate-related Financial Risk Management for Large Banks," which targets only banks with over $100 billion in assets. The Federal Deposit Insurance Corporation has also recently issued a draft of risk management principles with the same size threshold.

In contrast, publicly held community banks -- some with as little as $1 billion in assets – will be subject to the proposed requirements. Scalability, historically a hallmark tenet of both the Commission and the banking industry, seems to be generally disregarded in the Proposal. We are reminded that, in responding to the issuance of the Current Expected Credit Loss accounting standard – a standard that addresses the key activity of lenders, the SEC Staff released Accounting Bulletin No. 119, noting that:

> "Registrants may utilize a wide range of policies, procedures, and control systems in their allowance for credit losses processes, and these policies, procedures, and systems are tailored to the size and complexity of the registrant and its loan portfolio."

Such scalability appears lost in the Proposal. The climate-based management infrastructure implied in this Proposal will be so costly for the vast majority of banks in the U.S. – perhaps even the vast majority of all companies – that they will likely need to consider consolidation or avoiding the public markets altogether. This is neither good for the banking industry nor the U.S. economy. Companies and banks of all sizes are needed for a vibrant economy.

Climate-related financial risk expertise is sparse across the nation.

Such requirements also belie a realistic assessment of the climate risk and the climate-related financial risk environments. The disciplines are so nascent that the availability of expertise is extremely low and will likely be for the foreseeable future. ABA observes that the "financial expert" required in audit committees through the Sarbanes-Oxley Act is normally supported by a long-operating accounting industry infrastructure that operates through state-licensing and college-level education requirements. The financial expert is also provided a safe harbor under Item 407 in Regulation S-K.[22] No such infrastructure exists for climate risk or climate-related financial risk expert, yet the Proposal excludes any safe harbor for the person assuming such duties. In other words, the very few people who might actually qualify as an expert will be wise not to assume such potential liability. We do not believe the Commission intends this. A safe harbor similar to that detailed in Item 407 of Regulation S-K must be similarly provided to those considered to have expertise in climate risk or climate-related financial risk management.

Other prescriptive requirements may be confidential.

ABA agrees that information of climate-related financial risks can help some investors assess the risks facing registrants. However, significant prescriptive aspects of the Proposal appear to break long-held principles of disclosures. For example:

- **Scenario Analysis:** Given the immature state of modeling, including both the availability of appropriate quality data and the modeling, detailed disclosure of the assumptions used and projected financial impacts (in other words, the results) of scenario analysis performed by the company are likely to be highly unreliable for the foreseeable future. ABA notes that specific detailed results of regulatory financial stress testing, which currently forecasts less than three years of results, are not disclosed.

- **Data gaps within Scope 3 emissions disclosures:** The requirement to disclose data gaps within Scope 3 emissions estimates, and how they were handled, conflicts with how current data gaps in financial information are addressed. Traditionally, the registrant is assumed to be owner of the entire process, whether third-party processes or data are used. This specific proposal also ignores the reality that companies will evaluate their models and adjust initially derived estimates that are often of qualitative nature, based on the identified limitations of the data or model. Disclosure of such information will likely confuse investors into relying on precision and reliability that inherently does not exist.

[22] Among other things under Item 407, the designation or identification of a person as an audit committee financial expert does not impose on such person any duties, obligations or liability that are greater than those of any other member of the audit committee and board of directors.

- **Internal Prices of Carbon:** Companies that may use internal prices of carbon in their operations may often be doing so for pricing or other competitive purposes. Such a disclosure requirement would divulge confidential information.

Recommendations

With all this in mind, any final rule must be principles-based, explicitly reaffirming the current concepts of materiality (see also the separate discussions herein), scalability, reliability, confidentiality, and adherence to current disclosure protocols. As companies learn more about the risks they specifically face and how they will manage them, they will be able to communicate to their stakeholders in evolving and appropriate manners.

Additionally, a safe harbor similar to that detailed in Item 407 of Regulation S-K must be similarly provided to those considered to have expertise in climate risk or climate-related financial risk management.

APPENDIX D: Scope 3 Financed Emissions Metrics are often not Decision-useful

The Proposal requires total Scope 3 greenhouse gas emissions (GHGs) to be reported "if material" or if the registrant has a set a target or goal for scope 3. With this in mind, financial services companies have unique treatment within the Greenhouse Gas Protocol, as Scope 3 emissions of banks include "financed emissions," which are gasses emitted within investments, including both equity and debt instruments. In other words, not only are Scope 3 emissions of a bank's operations to be estimated, but a portion of the emissions of borrowers (Scope 1, 2, and 3) in a lender's portfolio are then also included within the Scope 3 emissions measurement of the lender.[23]

While the SEC does not propose a quantitative threshold for materiality of Scope 3 GHGs, it notes that some companies support one, such as if Scope 3 GHGs are 40% of total GHGs. The 2021 TCFD Report notes that Scope 3 GHGs approximate over 90% of all commercial bank GHGs. If relying solely on quantitative bright-lines, Scope 3 GHGs are likely to be considered material to a banking organization's total GHG count.

That said, the Supreme Court-based principle of materiality traditionally used by the Commission is that "a matter is material if there is a substantial likelihood that a reasonable investor would consider it important when determining whether to buy or sell securities or how to vote." ABA believes that banks should perform their assessments of materiality made on the qualitative basis defined by the Supreme Court and, with this in mind, banks of various sizes, portfolio mixes, and physical locations will likely view that quantitative disclosure of total aggregate Scope 3 financed emissions across the entire lending portfolio to be unnecessary. In fact, many community banks may not disclose any financed emissions estimates (see Examples A and B) and certain banks will report financed emissions only pertaining to certain parts of their lending portfolios (see Example C). The Commission should recognize this, as a measurement of financed emissions will often provide no decision-useful information. This is because the materiality of Scope 3 financed emissions to a lender's transition risk (as understood by the Supreme Court) is conceptually different from typical Scope 3 emissions of other organizations.[24]

Most Scope 3 financed emissions are not necessarily reflective of transition risk.

While the Proposal discusses the benefits to investors of a total Scope 3 GHG disclosure in terms of addressing climate-related transition risk, the Commission should recognize that the aggregate

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[23] See Category 15 of the *GHG Protocol Corporate Accounting and Reporting Standard.*

[24] In addition to the discussion here related to the materiality of Scope 3 financed emissions, see Attachment F, which discusses the overall need to assess current GHG measurement standards by the Greenhouse Gas Protocol and by the Partnership for Carbon Accounting Financials (PCAF). These standards, developed specifically to assist companies in setting and working toward climate-related targets and not for the sake of investor reporting in compliance with Regulation S-K standards, may provide incomplete information compared to investor expectations. Before any Scope 3 financed emission disclosure requirements are adopted, evaluation will be needed of these standards as they relate to investor expectations.

emissions of a financial institution's borrowers will not provide insight into the financial institution's transition risk. In fact, financed emissions only relate to transition risk to the degree that the transition events or activities would affect a borrower's ability to repay the loan. With this in mind, Scope 1 and Scope 2 emissions, which make up part of a financial institution's Scope 3 emissions, do not accurately provide any context or insight into a borrower's credit quality. Since credit quality is such an important driver of bank performance and financial position, financed emissions estimates may often obfuscate any related analysis. Other ways in which transition risk resulting from financed emissions are different from Scope 3 emissions reported by other companies include:

- GHGs related to consumer loans will often be double counting those reported within commercial loans.

  For example, the Scope 3 emissions reported by an auto manufacturer (and reported as financed emissions by the lender) already includes estimates of the gasses emitted by the end consumer by driving the car. If that consumer was issued a loan to purchase the car, the related consumer's GHGs double-count those of the manufacturer. Emissions of energy utility companies to supply heat and electricity will normally be double counted within residential housing emissions measurements, too.[25]

  Such double counting of emissions can commonly occur not only because of consumer loans, but also of loans to different companies within the same value chain. Further, investment funds that include multiple financial institutions will likely have significant double-counting. Monitoring and matching value chain participants in order to avoid the double-counting of financed emissions is an arduous process and doing so between financial institutions may be impossible.[26]

- The transition risk of certain financed emissions will often be immaterial, compared to other financed emissions.

  It is understandable how Scope 3 GHGs can be indicative of climate-related financial transition risk for many manufacturing companies. When Scope 3 GHGs are significant for these companies, changes in market factors or regulation can vastly change the demand for their products or the costs of their operations. Companies emitting low total GHGs (including Scope 3) may have advantages over competitors with high GHGs. This could present challenges to a bank's lending portfolio.

[25] With this in mind, double- and triple-counting emissions from energy utility companies also occurs within unsecured consumer loans and measuring such double-counting can be particularly challenging over and above the difficulty of measuring emissions within unsecured consumer loans. Understanding that the utility's Scope 1 emissions can be double-counted in both a borrower's unsecured consumer loan and the residential mortgage loan is relatively easy. Measuring the double- and triple-counting is very difficult.

[26] There are operational challenges related to measuring financed emissions within the inter-institution lending that is common to financial services industries. However, industry vs. industry analyses using financial metrics are commonly performed by investors. ABA expects such comparisons to initially be attempted by analysts.

This is not so for many other entities that borrow from banks. Their related GHGs are not nearly as indicative of transition risk as those of manufacturers. Using auto loans as an example, the demand for the related automobile (and, thus, the vast majority of the transition risk) has already been fulfilled. While regulation or market demand may affect the collectability of the auto manufacturer's loans, it is highly unlikely that they would affect the consumer's driving or other living habits to significantly affect the collectability of the loan. In other words, the GHGs related to the auto loan are a poor indicator of transition risk.

- Risks within Scope 3 GHG financed emissions of banks are significantly different from the Scope 3 GHGs of a bank's borrowers.

  Other lending products can present the same situation as just described. For example, the estimated financed emissions in most consumer lending would likely have little indication of transition risk to the bank. ABA also believes estimates of financed emissions on most commercial and consumer real estate loans may not be good indications of transition risk to the lender for the same underlying reason. The demand for the underlying products (in these cases, developed houses or buildings) has normally been fulfilled (or will be satisfied in the relatively short run, with transition risk being of nominal impact). ABA acknowledges that transition risk can be significant to the ongoing operations of the borrowers in these cases. However, that transition risk is not nearly the same to the lender.[27]

Scope 3 financed emissions are not necessarily reflective of transition risk to community bank portfolios.

The size and breadth of the community banking industry in the U.S. is unique compared to other countries. Of the approximately 4,800 banks in the U.S., several hundred of them are SEC registrants that are community banking organizations.[28] This is far larger than the community banking industries in other countries and their business models often revolve around their individual commitments to the communities they serve. With this in mind, many community banks in the U.S. serve individual communities that have significant concentrations of

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[27] Some may point out that emissions in the development of commercial real estate buildings are significant and should be reflected in financed emissions. ABA does not argue against that, but notes that the financing of the development of commercial real estate is normally different from the permanent financing, often performed by different lenders. Measurements of financed emissions of real estate construction, therefore, may have little ongoing relationships to transition risk. Possibly due to this, the PCAF guidance for financed emissions does not require measurement of the construction-related Scope 3 financed emissions, but only the ongoing operations of the related collateral.

[28] As previously noted, to qualify as a "smaller reporting company" (SRC) and be exempt from the Scope 3 GHG measurement requirement, a company must qualify under revenue and float considerations. ABA is aware of banks of $1 billion in assets that are disqualified from the SRC designation, though banks with over $3 billion assets generally do not qualify. The vast majority of community banking organizations would likely fall under the proposed Scope 3 reporting requirement.

commercial enterprises related to carbon-based energy exploration and production. Divestment from these communities, including the individuals and companies of the communities, is not an option for these banks.

Working with their regulators, community bankers are already cognizant of industry concentrations in their lending portfolios and many are already in the beginning stages of formally assessing climate-related financial risks to their organizations. However, measurement of specific GHGs in their loan portfolios will not provide them, or their investors, decision-useful climate risk-related information over and above their existing analysis of industry concentrations. In other words, the climate risks facing their communities are often self-evident, with a measurement of total GHGs being immaterial to portfolio decisions facing both their management and their investors.

Of course, many community banks serve communities that are not dependent on carbon-based energy companies. Some of these institutions are interested in assessing their climate risks and are even considering accessing third party databases to begin to understand the footprint of their lending portfolios. While the third-party data will provide these banks general information as to certain GHG levels, the banks are planning to refer to such information only if there are significant changes to the industry concentrations within in their loan portfolios. Portfolios of these banks often concentrate in commercial and residential real estate projects in communities that are often supported by companies in the high technology or professional services industries. Like the banks in petroleum-related communities, their investors have not asked for Scope 3 GHG levels, as these investors know that exposures within their community to those energy, transportation, and other high-emitting industries are limited. In these situations, measurement of Scope 3 financed emissions that is subject to the stringent internal controls similar to those over financial reporting will be prohibitively expensive without providing additional decision-useful information to their investors.

Recommendation

As with any information provided to investors, disclosing Scope 3 financed emissions would normally be required only if considered material in the qualitative sense defined by the Supreme Court. The Commission's redefinition of the "materiality" concept (as discussed in Appendix A and B), however, now confuses the proposal to report Scope 3 emissions "if material".

With this in mind, ABA recommends, first, that the Final Rule eliminate the reference to "material" Scope 3 emissions. More importantly, ABA urges the Commission to limit any required disclosure of Scope 3 emissions to publicly announced climate-related targets and exclude emissions (including any financed emissions) not included in a target. For the various reasons explained above, this would exclude estimates of financed emissions in significant portions of many bank portfolios, as well as complete portfolios of many community and regional banks.

ABA observes that, in accordance with banking agency guidance related to concentrations of credit risk (both within the "Comptroller's Handbook: Concentrations of Credit" and within Pillar 3 reporting for large institutions), publicly held banks manage and disclose credit

concentrations in their lending portfolios, disaggregated by relevant industry and geography. We believe that a significant and effective transition risk assessment can be easily performed through review of such information. A principles-based final rule that emphasizes materiality of climate transition risk will likely result in disaggregation of those exposures that may more explicitly address the key specific industries identified in the TCFD reports (Energy, Transportation, Materials and Buildings, and Agriculture, Food, and Forest Products).

Examples of Financed Emissions Materiality Decisions

When assessing whether to clarify the materiality of financed emissions, ABA urges the Commission to consider the following examples:

Example A – Size of the institution: (Note: Smaller reporting companies (SRC) are exempt from reporting Scope 3 emissions. We estimate that banks with assets generally as low as $3 billion may often exceed the revenue and float criteria to qualify as SRCs.)

Community Bank A has $5 billion in assets and does not qualify as an SRC. Its loan portfolio has significant concentrations in consumer residential mortgages and commercial real estate loans for multifamily and industrial (medical) purposes. Its community footprint has very little exposure to the energy, transportation or agriculture industries. Further, through its routine outreach to investors and analysts, Community Bank A has noted that, while its lending portfolio has significant concentration to the materials and building sector, there is little to no interest from investors related to financed GHG levels and management believes prospective investors would have little interest in Community Bank A reallocating its assets. Therefore, bank management concludes that specific measurements of Scope 3 financed emissions are not material to investor decisions.

Example B – Physical Locations: Community Bank B operates within a community that is largely supported by companies relating to fossil fuel-based energy production. Its commercial loan portfolio consists mainly of energy producers and related servicing companies. Community Bank B currently discloses the amount of loan exposure within its commercial portfolio by industry. However, bank management also discloses that it believes that virtually the entire portfolio – commercial and consumer – is subject to high transition risk. In other words, significant declines in market demand for or regulatory actions related to the costs of petroleum products would adversely affect the entire community. As a result, believing it will add little incremental value to an investor's analysis of its climate risk through a review of credit concentrations, Community Bank B considers measurement of its Scope 3 financed emissions to be immaterial to investor decisions and decides not to disclose its Scope 3 financed emissions.

Example C – Portfolio mix: Bank C manages a broadly diversified lending portfolio that includes both commercial and consumer loans. While its consumer loan portfolio and its high-technology commercial loan portfolios are significant portions of its total lending exposure in a monetary sense, most Scope 3 financed emissions are generated through loans to petroleum energy producers and suppliers. This bank has a climate-related strategy to reduce its Scope 3 emissions over the long run and, as it has publicly announced, it centers solely on reducing the

emissions within the energy portfolio. As a result, this bank determines that Scope 3 financed emissions outside of its energy portfolio are immaterial to the total Scope 3 emissions, as well as to its climate strategies. Bank C decides that only those financed emissions within the energy-related loans will be disclosed.

APPENDIX E: Disclosure Safe Harbors Need Expansion, GHG Estimate Practices Need Practical Review

Safe harbor is needed for all statements regarding climate-related risks.

Many registrants will be implementing climate risk management systems for the first time. In light of this, financial regulators worldwide have acknowledged significant gaps in climate risk-related data and how such data translates into climate-related financial risk for banking institutions. As a result, considering this nascent and evolving stage of climate-related financial risk management, it is likely that companies of all sizes will struggle in implementing effective and stringent internal control processes over modeling, particularly over scenario analysis, climate-related target setting and forecasting, and other measurement of current or forecasted climate-related financial risk. In other words, we believe that the underlying systems and data that are meant to provide the "reasonable basis" upon which forward-looking statements receive the safe harbor may often not be considered sufficiently reliable when it comes to climate-related financial risks. As a result, many companies will be hesitant in fully discussing how they view the climate-related financial risks they face, and ABA believes this is not what the Commission intends.

The Commission has expanded the current safe harbor provision, but only to apply to Scope 3 greenhouse gas emissions disclosure. This is insufficient for the reasons just noted. ABA, therefore, recommends that a safe harbor be established over *all* climate risk-related statements. If the Commission wants substantive discussion of climate risk by its registrants, an expanded safe harbor applying to all climate-related disclosures will be necessary. Such an expansion may be considered for a specific period of time or could clarify that the "reasonable basis" of the safe harbor would apply to situations where the company is not aware that underlying data or modeling assumptions are demonstrably false.

Scope 3 GHG disclosure safe harbor must be expanded, and practice expectations clarified.

Information currently disclosed within existing Regulation S-K requirements is generally subject to robust governance and internal control processes that include assessing and testing the effectiveness of relevant systems. In addition to the difficulties noted above related to modeling and forecasting climate-related financial risk, ABA believes many companies will struggle in designing and executing effective Scope 3 GHG measurement systems, putting into doubt whether the proposed safe harbor relating to Scope 3 GHG disclosures[29] will be effective. Estimating Scope 3 GHGs across a value chain, compounded by a bank's responsibility to track them for each borrower, is a significant and costly challenge.

For example, banks currently estimate that it may take twelve to fifteen months for updated and reliable measurements of Scope 3 GHGs to be estimated across their borrower value chains. In addition to significantly complicating a bank's process to assess the reasonableness of estimates

[29] Under the proposed safe harbor, Scope 3 GHG information would generally not be considered fraudulent unless it was shown that the statements lacked a reasonable basis or were not made in good faith.

received by other individual companies in the related value chain, such stale data may often not be considered a "reasonable basis" upon which estimates or representations can be made at a specific point in time. Thus, the proposed safe harbor may not be effective.

Considering this, the Commission must expand or otherwise clarify the proposed safe harbor so companies that do not have effective internal controls over GHG accounting systems may, nevertheless, be considered to have made estimates in good faith. The use of data that may be greater than one year old must also be allowed as an acceptable practice. This practice alone warrants consideration of allowing registrants to "furnish," rather than "file" Scope 3 emission information (including any related information on targets), thereby alleviating exposure to liability.

With this in mind, ABA observes a significant difference in internal control expectations relating to measurements made in accordance with the Greenhouse Gas Protocol for current corporate sustainability reporting and those that are likely necessary under Regulation S-K. This is critical because it puts into question when the proposed safe harbor is in effect – in other words – whether the underlying systems of procedures provide a sufficient "reasonable basis" upon which such statements are made. For example, primary reliance on information from third party databases for emissions factors is routinely placed by companies using the Greenhouse Gas Protocol without going through the significant ongoing internal control processes performed on the underlying data that are normally a part of internal controls over financial reporting (ICFR).

Current internal control practices for financial reporting would generally help ensure third party database information is relevant (emission factors sufficiently reflect specific activities being measured by the individual company) and reliable (factors reflect calculations inputted, calculated, and summarized in a complete, accurate, and timely fashion). Control assessments are normally performed over third-party service providers and specialists, over each of the databases that are used, and over the companies that use such data. Common practices also include reference to independent Service Organization Controls ("SOC-1") reports. Due to the complexity of designing internal control systems, it is not uncommon for banks to refrain for three years before significant reliance is placed on such systems.[30] Whether or not Scope 3 emissions would be subject to a "reasonable assurance" attestation or not,[31] such a process is assumed to be required.

ABA believes that the Commission may not intend for registrants to place wide and primary reliance on third-party emission factor databases that are not subject to the rigors of current

[30] The use of third-party databases in the banking industry is significant, but not to place sole or primary reliance on the data for the sake of reported estimates. Entries into the third-party databases are also typically either subject to audit (as in regulatory call reports) or otherwise subject to significant market-related scrutiny because access to it is publicly available and used as a basis for financial transactions. The use of third-party databases for the purpose of Scope 3 emissions estimates reported in a company's annual report, therefore, would likely require the internal control processes noted above.

[31] If the Commission were to maintain a publicly available database that housed emissions metrics reported to it by registrants, it is reasonable, assuming adequate security over the database, that no SOC-1 assurance may be considered necessary, since reported amounts were subject to stringent internal control processes.

internal control practices used over financial reporting and disclosures. If so, the Commission needs to clarify this, along with any expectation of future compliance and it also must clarify how the safe harbor will function in such an environment. The costs of implementing ICFR over Scope 3 disclosures will be dramatically different, and especially for those institutions that must report financed emissions, from those the Commission likely assumed in the Proposal. Such a discrepancy in estimated costs must be considered before any final rule is issued.

Recommendations

An expanded safe harbor applying to all climate-related disclosures is necessary. Such an expansion may be considered for a specific time period or could clarify that the "reasonable basis" of the safe harbor would apply to situations where the company is not aware that underlying data or modeling assumptions are demonstrably false.

The Commission must also expand or otherwise clarify the proposed safe harbor related to Scope 3 disclosure so companies that have identified weaknesses in their internal controls over GHG accounting systems may, nevertheless, be considered to have made estimates in good faith.

Significant discussion must take place with registrants and with investors prior to the effective date as to acceptable practices, including internal control expectations as well as the use of data that may be greater than one year old for Scope 3 estimates. The estimated costs of compliance must be modified accordingly.

In addition to the safe harbors just noted, we recommend consideration of setting deadlines for the submission of all greenhouse gas emission information separate from and after the rest of the annual filing. Further, recognizing that most companies are likely to not have performed estimates of greenhouse gas emissions in periods prior to the adoption date (or before initial listing), the Commission must also allow for companies to report such information only on a prospective basis, rather than requiring previous year information.

APPENDIX F: A Significant Review of Scope 3 "Financed Emissions" Practices is Needed to Ensure Operability and Usefulness to Investors; More Transition Time will be Needed.

If, despite the discussions and recommendations in Appendix D, the Commission requires disclosures of Scope 3 financed emissions, a thorough review is needed to ensure such disclosure complies with investor expectations. Such disclosures will be costly to produce, but will still likely not capture significant activities that may be of interest to investors. The following is a discussion of the state of financed emissions standards and processes to collect and measure the related information in a manner that complies with Regulation S-K. This discussion concludes with specific recommendations if such disclosure is required.

Background

The SEC Proposal and the GHG Protocol

The Commission proposes to require disclosure of greenhouse gases (GHGs) emitted by registrants, disaggregated by seven different GHG types,[32] and reported in accordance with "scopes" defined by the *Greenhouse Gas Protocol Corporate Accounting and Reporting Standard* (GHG Protocol).[33] Scope 1 represents gases directly emitted by the company; Scope 2 gasses are indirect emissions (those normally purchased from a local energy company),[34] and Scope 3 emissions are other indirect greenhouse gasses emitted through value chain partners of the registrant. This disclosure will be accompanied by carbon-equivalent intensity metrics (GHGs per revenue, for example) for each company. All SEC registrants will be required to disclose Scope 1 and 2 GHGs, while companies not qualifying as a "smaller reporting company" will be required to report Scope 3 GHGs if material or if the company has publicly made an emissions target related to Scope 3 GHGs.

Scope 3 Financed Emissions and the PCAF Standard

Under the *GHG Protocol*, Scope 3 consists of the measurement of 15 different categories of activities throughout a company's value chain, which includes upstream suppliers and downstream users of its products, and even those emitted by the user of the product. For example, a portion of GHGs emitted by a consumer driving an automobile would be recognized by a supplier of parts that are assembled to manufacture the doors of the automobile. Scope 3 GHGs also include gasses emitted through equity and debt instruments.[35] When material, this

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[32] The gases are carbon dioxide (CO_2), methane (CH_4), nitrous oxide (N_2O), nitrogen trifluoride (NF_3), hydrofluorocarbons (HFCs), perfluorocarbons (PFCs), and sulfur hexafluoride (SF_6). Throughout this attachment, greenhouse gases will be referred to as "gasses," "emissions," or "GHGs."

[33] https://ghgprotocol.org/corporate-standard

[34] Only Scope 1 and Scope 2 GHGs will be reported by the seven kinds of gasses.

[35] See https://ghgprotocol.org/standards/scope-3-standard.

requires banks to measure and accumulate Scope 3 emissions of the borrowers in their lending portfolios. These are referred to as "Financed Emissions."

Banks that are currently managing financed emission targets in their lending and investment portfolios do so by focusing on various metrics, which may be based on absolute emissions, emissions intensity, or other measures and these metrics are normally applied to specific portions of their lending portfolios. Estimating emissions that are considered attributable to specific financing, however, is complicated, involving various judgments and assumptions. To create common practices in the estimate of financed emissions, a group of banks formed the Partnership for Carbon Accounting Financials (PCAF).[36] Building off the principles of the *GHG Protocol Corporate Accounting and Reporting Standard*, PCAF has provided attribution formulas to estimate the proportion of a borrower's GHGs considered "financed" by the lender. Specific other guidance is also provided related to varying acceptable levels of data quality and the specific emissions that should be included in the estimate. These are currently included in PCAF's *The Global GHG Accounting and Reporting Standard for the Financial Industry (The PCAF Standard).* PCAF also maintains a GHG database that can be used as a basis for member estimates. While a growing number of banks have joined PCAF, not all banks currently plan to use the PCAF methodology, and it is likely that banks who are actively managing GHG measurements in their lending portfolio may not always ultimately adopt PCAF.

As of May 2022, *The PCAF Standard* has created specific guidance related to several classes of loans:

- Listed equity and corporate bonds
- Project finance
- Mortgages
- Business loans and unlisted equity
- Commercial Real Estate
- Motor Vehicle Loans

Full-scale scope 3 GHG accounting systems may be needed under the Proposal.

As currently proposed and if considered material, disclosure of Scope 3 greenhouse gas emissions – and more importantly, financed emissions – will likely draw significant scrutiny from stakeholders, especially in subsequent years after adoption as they focus on whether yearly changes in financed emissions conform to expectations. As a result, issues that companies (and their financial institutions, when considered material, for the sake of financed emissions) must likely address include:

1. Emissions based on segments of the business.
2. Emissions based on specific industry sector or loan portfolio
3. Changes in emissions and intensity levels from year to year, and specifically on whether changes in reported emissions were the result of;
    a. Actions of the bank credit activities (e.g., through growth or contraction in overall assets or through reducing the relative bank exposure to high emitting industries),

[36] https://carbonaccountingfinancials.com/

b. Actions of the borrowers (for example, emissions would decrease by adopting low-carbon operations or would increase through their business growth),
c. Actions of the bank or borrower finance activities (e.g., business combinations and restructurings),
d. Actions of the general market (which can result within the PCAF attribution formula for publicly traded investments), or
e. Changes in data and modeling methodologies.

Changes in these impacts will help stakeholders (both internal and external) to understand how the company is managing toward any GHG targets. With this in mind, there are no such systems in place to report and explain such performance at this early time. Significant time will be necessary to design, test, and implement such systems.

Financed emissions accounting guidance is limited in scope.

While PCAF has made significant progress in assisting banks to set and manage their climate-related targets, the PCAF standard is not yet comprehensive in its scope. PCAF is currently considering additional issues across a variety of activities and asset classes.[37] More challenging, however, the PCAF Standard is focused solely on lending portfolios recorded on a balance sheet at a reporting date. As a result, certain activities in which emissions are financed or facilitated will be out of the scope of disclosure:

1. Emissions on loans purchased and/or sold during the year (performed in the normal course of business, through securitization, and through mergers),
2. Emissions through short-term and transaction-based financing originated and maturing within the year,
3. Emissions affected through new and matured loan commitments,
4. Other facilitated emissions, bank services, loan servicing, custody services, etc.

Further discussion would also need to take place related to lending facilities commonly provided to corporate customers for specific operational purposes that are not contractually defined or linked to specific collateral.

All of these additional issues would require tracking of individual transactions, taking into account specific timing and cost accounting for the sake of accurate GHG attribution. This is all very complex to operationalize, which is likely a key reason PCAF decided to limit the scope of its Standard. With this in mind, however, unless a comprehensive GHG accounting is implemented, bank performance metrics will likely be distorted, and stakeholders may base investment and voting decisions on inaccurate assumptions of financial institutional involvement within certain key GHG-emitting activities.

[37] For example, PCAF has committed to consider and publish explicit guidance on calculating GHG emissions for some financial products not currently addressed by the PCAF Standard, including private equity, investment funds, green bonds, sovereign bonds, loans for securitization, exchange traded funds, derivatives and initial public offering (IPO) underwriting.

With this in mind, ABA also believes a review of the GHG Protocol and the PCAF Standard is needed for certain high-exposure industries in order to ensure treatment is comprehensive, consistent and comparable between industries and in line with current stakeholder expectations.

Examples include:

1. Real estate development is a key industry sector identified in the TCFD report. However, construction emissions are not normally required to be reported under the PCAF standard. Further, while financed emissions include Scope 1 and 2 emissions of the building operations only, ABA believes that investors may further want to understand if lessees of the underlying properties are fossil fuel producers. Scope 3 emissions measurement may be necessary.

2. Significant aspects of consumer lending (namely, unsecured lending and home equity lending) are generally excluded from GHG attribution. While the underlying reasons for this exclusion are understandable for materiality purposes[38], such an exclusion can have unintentional consequences when revenue-based and intensity metrics are used to compare risk and performance between companies. In short, banks that concentrate on consumer lending will generally have better Scope 3 greenhouse gas performance metrics than commercial lenders and unsecured lending would be favored over secured lending. For the sake of comparability within consumer lenders, consideration of standard consumer GHGs may need to be considered.

3. The GHG Protocol points out how customer travel can be an integral aspect of a company's Scope 3 emissions.[39] With this in mind, in light of the dependence on customer travel of certain industries (hotel and tourist-based companies, for example),[40] ABA believes most companies do not normally track the GHGs of its customers in traveling to and from their stores or sites. As GHGs are considered a metric of transition risk under the Proposal,[41] then including such GHGs within a company's total emissions may be appropriate for risk

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[38] See Appendix D addressing how different GHG measurements can represent different risk to the lender.

[39] See the article on page 31 of the GHG Protocol. In this case, IKEA estimates the travel of its customers to and from its stores.

[40] See Carbon Trust 2006 study "The Carbon Emissions Generated in All We Consume", which claims that "Consumer purchasing decisions are the ultimate driver of carbon emissions in an economy." It notes that "recreation and leisure activities" is the consumer need that produces (as of 2006) the most carbon in the United Kingdom, with a large portion of it relating to transportation. https://www.carbontrust.com/resources/the-carbon-emissions-generated-in-all-that-we-consume

[41] Per "Benefits" cited in the SEC Proposal related to disclosures of "GHG Emissions Metrics", analyses related mainly to transition risks were cited.

analysis, as well as for consistency and comparability. This can be a significant issue for banks, as hotels can be a significant sector within commercial real estate lending portfolios.

Internal control standards may not conform to current investor expectations. [42]

In addition to the need for comprehensive GHG accounting systems, auditing and risk management organizations must review standards to develop expectations related to internal control processes and documentation that address:

1. Double- and triple-counting of GHGs (which occur when a bank has loans outstanding to more than one borrower in a value chain) that are currently accepted norms in the GHG Protocol and PCAF standards,

2. Varying levels of data quality that are acceptable within both the GHG Protocol and PCAF Standard that may not be acceptable for SEC disclosure purposes, and

3. Reliance on third party data that may be used as a primary basis for many GHG estimates. Such data may not often have been subject to the same level of data quality and reliability processes that are routinely applied to financial data sources.

Estimates may need to rely on untimely data.

ABA members who have significant commercial lending operations report that data necessary to obtain, evaluate, and reliably estimate the Scope 3 emissions across borrower value chains is normally one to two years of age. In other words, a current estimate of Scope 3 emissions for a borrower will rely on data that is up to two years old. This is due to the time it takes for companies to perform their own estimates, consider how the amount of relevant supplier emissions fit into their estimates, and then how their customers (and other downstream partners) use their products. This challenge is then exacerbated during foreclosures, business combinations, and other transactions, both within the financial institution and a borrower's value chain, that may change the attribution of measured emissions.

The Proposal allows certain estimates to be made in fourth quarter measurements of Scope 3 emissions. However, given the protracted length of time and the volatile market dynamics of many products each year, it is likely that the use of such stale data may result in estimates of little decision-usefulness to investors.

Further, in light of the large percentage of municipal securities held by banks (and especially community banks[43]), ABA also understands that timely availability of financial statements issued by municipalities and their related units is a problem and it seems reasonable that similar delays

[42] See also discussion in Appendix E related to safe harbors needed, as well as clarification of practice expectations.

[43] Banks with under $10 billion in assets now hold an average exceeding 5% of their total assets, while banks over $100 billion in assets average under 1%.

would likewise occur over their GHG estimates. Both this situation and the reality above of the inability to obtain reliable and timely value chain information puts significant doubt as to the reliability of Scope 3 financed emissions estimates made by banks. Due to the volatility of specific markets, it is difficult to understand how management and investors will sift through the information to assess the climate risk implied by these estimates. Significant discussions are needed to assess actual investor needs as well as the processes and internal controls needed to reliably satisfy those needs. Consideration of deadlines related to GHG estimates should be considered as part of a larger effort to identify and address investor needs for decision-useful information.

Recommendations

In Appendix D, ABA notes that it is likely that a measurement of Scope 3 financed emissions may not often provide material information to investors. As a result, ABA recommends Scope 3 emissions disclosures be limited solely to publicly announced emissions targets and goals. However, if a common standard to measure financed emissions is considered necessary, significant work is needed to ensure that disclosed Scope 3 emissions attributed to bank activities are comprehensive, in line with investor expectations, and can be accounted for in a controlled manner. As part of this, a detailed review is recommended of both the GHG Protocol and the PCAF Standards, of the practical challenges to obtaining timely information, as well as of guidance by auditing and internal control organizations.

Such a process will require a minimum of two additional years beyond the transition periods provided in the Proposal. The Commission should also consider other practical recommendations:

- Specific guidance should allow aged information to be relied upon.
- Alternate (later) yearly deadlines should be considered for greenhouse gas emissions disclosure submissions. They may partially alleviate the challenges related to data availability.
- As previously noted, since it is likely that companies will not have previously performed measurements of any of Scope 1, 2, or 3 emissions, registrants should be allowed to submit only current year information at initial adoption, rather than information for all reported years in which financial statements are presented.

Recognizing that financial institutions may develop evolving and effective ways to track or otherwise manage the climate footprints within their investment and lending portfolios, endorsement of specific greenhouse gas accounting frameworks is unnecessary. A principles-based Final Rule will likely be the most efficient way for companies to address evolving investor needs for decision-useful information.