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Business as unusual

Assessing legislative challenges to common ESRM practices

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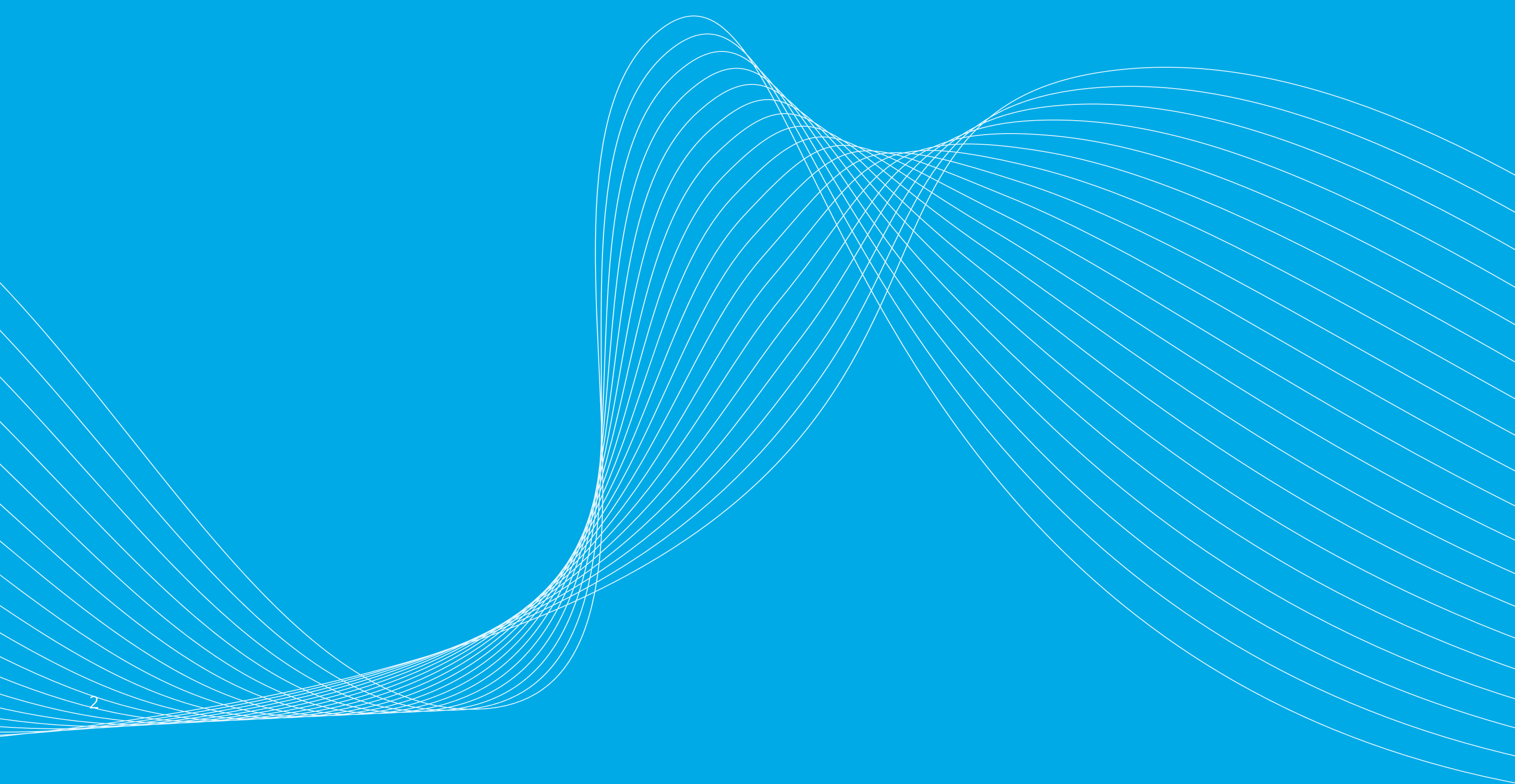

Introduction

By now, environmental and social risk management (ESRM) has become ingrained in the processes many banks and other financial institutions use to manage risk and mitigate the potential for environmental and social (E&S) adverse impacts.

Their rationale for adopting such programs is typically twofold: 1) they understand that failure to address such risks could affect their customers' future revenue streams and ability to meet their financial obligations; and 2) they recognize that stakeholders are demanding increased transparency and engagement around how banks and other lenders are accounting for those risks as gatekeepers of capital.

Importantly, the identification of potentially significant environmental or social issues doesn't rule out a business relationship. In many such cases, the financial institution works with the client to better understand the E&S risks associated with the client's operations and their implications to establish appropriate safeguards that protect both organizations' mutual long-term interests. Therefore, ESRM not only makes strong business sense from a credit, operational, and reputational risk perspective but also supports the communities and the environment in which the client operates.

Recent pieces of legislation passed at the state government level have sought to address ESRM practices that some perceive as amounting to discrimination against industries often associated with high E&S risk. Dubbed "fair access" laws, they seek to prevent financial institutions from considering environmental, social, and governance (ESG) factors in financing and investment decisions, based on their reading that such practices can unfairly discriminate against certain commercial industries.

These developments have put some lenders in an awkward position, threatening their revenue streams in large parts of the country and even prompting some to withdraw from certain markets. Rather than encourage financing activity, the laws can have the perverse effects of reducing the availability of credit and increasing the cost of financing in affected communities due to fewer choices (see page 4).

This paper reviews these new laws against the backdrop of ESRM becoming a standard part of due diligence and proper risk management in financial institutions. It also seeks to provide guidance on how financial institutions can defend their E&S risk decisions by highlighting the individual, quantitative risk analysis that forms the basis of leading ESRM programs.

Caught in the middle

In 2020, the Office of the Comptroller of the Currency (OCC) proposed a "fair access" rule that would prohibit banks from discriminating against commercial industries, taking aim at banks that had ESG policies that restricted their ability to do business with certain industries due to climate or other concerns.

The proposed rule prompted legal challenges and was put on hold the following year by the next US administration.[1] Nonetheless, it inspired legislation at the state level that sought to protect local industries. In September 2021, for instance, a new law took effect in Texas that prohibits state agencies from working with a bank that has ESG policies against companies in the fossil fuels and firearms industries.[2] In May 2020, Florida enacted its own fair access law making it illegal for banks to engage in "unsafe and unsound practices," defined as denying or canceling financial services to a customer based on factors such as their political opinions or affiliations, or the use of any ESG rating or social credit scoring mechanisms.[3] Tennessee and Oklahoma have since passed their own fair access laws, and at least eight other states are mulling similar steps.[4]

In November 2023, the OCC's general counsel issued a letter to the CEOs of all national banks and federal savings associations under its purview, expressing concern about the impact of such laws on their ability to provide banking services that are "consistent with safety, soundness, and the fair treatment of customers."[5] The letter also stated that state laws imposing requirements such as attestation on national banks "may be inconsistent with the OCC's exclusive visitorial authority under federal law."[6]

These new fair access laws passed by select states may contradict disclosure mandates around the reporting of E&S risks in other jurisdictions. The Corporate Sustainability Reporting Directive (CSRD), for one, requires more than 50,000 global organizations to disclose details around how they are managing E&S risks within their value chains. In addition, states such as California, New York, and Washington have climate disclosure laws requiring companies to disclose their climate-related financial risks and how they plan to adapt to them.

In Texas, some banks have been barred from doing business with the state as a result of its new law.[7] Five of the largest underwriters in the state have exited the market; historically, those banks underwrote about 35% of the municipal debt in the market. The decrease in competition left by their exodus means that Texas cities will pay as much as $267 million more in interest on their bonds, according to one recent Wharton study examining the law's impacts.[8]

Meanwhile, a study commissioned by the Oklahoma Rural Association estimates the state has experienced a 15.7% increase in its municipalities' borrowing costs due to its Energy Discrimination Elimination Act (EDEA), adding nearly $185 million in additional expenses as of April 2024. It concluded that EDEA and similar laws passed in the state "are burdening taxpayers and hampering investment in and development of critical public projects."[9]

A comprehensive analysis of proposed state laws similar to the Texas model estimated that taxpayers in six states could be on the hook for as much as $708 million in additional costs related to higher interest rates if some bond underwriters are forced out, stymying competition.[10]

Ingrained in normal risk management

At the crux of the issue is how banks and other financial institutions incorporate E&S impacts as part of their regular risk management policies and practices. As outlined in their texts, many state bills and regulations reveal suspicions that banks are routinely and categorically deciding not to engage with certain companies based on the industries in which they operate.

However, in some instances, extending credit or some other financing solution to a potential client in an at-risk industry or activity, irrespective of its environmental or social record, ignores factors that could affect its ability to make good on its obligations. Take the example of a thermal coal mining company seeking financing to build out production; public pressure to ween society off coal (including mandates for alternative power generation) have to be considered in the company's financial due diligence since it could dramatically affect future demand and revenues. Or consider another case involving a company that regularly scores poorly on measures of gender-based and racial equity; if it develops a reputation for not supporting equity within its leadership ranks, it could fail to attract fresh talent needed to compete.

In their ESG disclosures, banks regularly outline their thinking about lending to businesses in high-risk sectors. A large US bank points out that it lends to companies in sectors that are associated with E&S risks, but not before carefully assessing the impacts and working with the client to "apply a clearly defined set of international standards and good practice to mitigate and manage environmental and social risks and impacts."[11] Another US bank explains that the purpose of its Environmental and Social Risk Policy Framework is to help "reach informed decisions about transactions and client relationships in sensitive areas in an efficient and consistent fashion." Furthermore, it describes the bank's process as "client specific, deal specific and subject to governance review that considers a range of risks that are evaluated through our Risk Framework, as are all transactions and client decisions, in the ordinary course of business."[12]

ESRM due diligence is therefore vital to understanding risk—when such risk is mismanaged, it is a driver of other risks, from credit to operational to market risk. Because of this, there's a strong argument that such evaluations fall under exclusions to the new fair access laws because they are part of routine due diligence and performed on a case-by-case basis. Texas's law, for example, provides a carve-out for any activities that serve "an ordinary business purpose." Florida's law requires that banks make determinations about the provision or denial of services based on an analysis of risk factors unique to each individual current or prospective customer.

When done right, an ESRM program can check both boxes. While a financing decision may flag a company operating in a sensitive industry or areas where caution is warranted, those evaluations should then lead to further engagement with the client, not outright rejection. Since 2003, 130 banks in 38 countries have adopted the Equator Principles, a set of rules based on the International Finance Corporation's Environmental and Social Performance Standards that seek to manage the E&S risks of the large infrastructure and industrial projects that they finance.[13] Those rules hardly disallow financing to at-risk industries; rather, they allow banks to proceed as long as they ensure E&S impacts are "properly managed" (see IFC's *Performance Standards* on page 6 for more).

The assessment and management of E&S risks and impacts not only keeps other risks from cascading but can also help identify opportunities for engagement that can lead to better E&S outcomes. Evidence abounds that when companies effectively manage E&S risks, investors and other stakeholders place a higher value on them as a direct result (see *Paying attention to E&S risks pays off* below).

Paying attention to E&S risks pays off

Numerous studies have established a strong connection between managing E&S risk and improved financial performance. Here are a few recent examples:

- In 2021, a group of researchers reviewed the "100 best corporate citizens" between 2009 and 2018 and found that a commitment to environmental sustainability, consistent socially responsible conduct, and strong corporate governance were directly linked to increased market value and were a good predictor of future financial performance.[14]
- In 2022, a similar study reviewed the financial data and ESG scores of 150 publicly traded companies in the Standard & Poor's 500 index and found that those with superior ESG performance had better financial results and were valued higher in the market compared to their industry peers.[15]
- In 2023, researchers studied 3,332 companies over a 10-year period and found that ESG performance positively correlated with corporate performance for large-scale companies.[16]

IFC's performance standards

The International Finance Corporation's (IFC) Performance Standards on Environmental and Social Sustainability, introduced in 2006 and updated in 2012, provide guidance for IFC clients to "avoid, mitigate, and manage risks and impacts as a way of doing business in a sustainable way."[17] The eight standards cover a range of E&S risks and their effective management.

International Finance Corporation performance standards

Risk management
Assessment and management of environmental and social risks and adverse impacts

Labor
Labor and working conditions

Land resettlement
Land aquisition and involuntary resettlement

Biodiversity
Biodiversity conservation and sustainable management of living natural resources

Resource efficiency
Resource efficiency and polllution prevention

Community
Community health, safety, and security

Indigenous peoples
Respect for human rights, dignity, and culture of indigenous populations

Cultural heritage
Sites of archaeological, historical, cultural, artistic, and religious significance

Taking an evidence-based approach

Given all the uncertainty around fair access laws and which ESRM practices will be exempted or not, banks and other financial institutions should work to make sure their programs can hold up to increased scrutiny. In our support of financial services clients in establishing and evolving ESRM programs, we emphasize they adopt the four following principles:

No. 1 – Make risk assessments individual

Leading ESRM programs reflect emerging and evolving E&S risks associated with the clients and communities served and are developed in consultation with impacted stakeholders. While screening and categorizing transactions at a broad level helps flag potential issues, environmental, social, and governance due diligence (ESGDD) digs beneath the surface, examining individual risks and appropriate steps the company might take to mitigate them.

No. 2 – Use quantitative methodologies

Assessing and scoring clients or transactions with higher potential for E&S risks creates a consistent, objective, and evidence-based approach. One valuable tool in this respect is an environmental and social risk rating (ESRR), which assigns a numeric score to transactions based on the level of E&S risk associated with the company's operations and how well it is managing said risk, incorporating factors such as its capacity, commitment, and track record. A high score doesn't necessarily preclude a relationship —it's simply a red flag that might be addressed through a sustainable finance solution (the focus of our next paper in this series).

No. 3 – Provide opportunities for escalation

As with any other type of risk, it's vital that financial institutions maintain multiple lines of defense when it comes to managing E&S risks and knock down barriers that would keep first-line operators from coordinating with risk management and compliance and audit personnel. One way this can be accomplished is by establishing a governance decisioning committee composed of leaders across different enterprise functions, risk programs, and business lines.

Increased coordination between ESRM and second-line risk programs can improve E&S risk management as a driver of other risk types, while improved partnership between ESRM and the front-line businesses can promote new market opportunities. For instance, a bank that is considering a general purpose loan for a utility company that's operating in a water-stressed region might make it contingent (e.g., through a debt covenant) on the implementation of a water-recycling program, opening the door to a potential solution from the bank's sustainable finance team.

No. 4 – Prioritize industry engagement

ESRM is not about saying "no." It's about asking one overarching question: What are the conditions necessary to responsibly, sustainably, and economically provide a company with high E&S risk access to capital? Once those conditions are identified, it's up to the financial institution to engage with the client to understand the best path forward. Making summary judgments without those types of discussions only cuts off potential solutions that could provide mutual benefits.

ESRM as a pivotal prod

We believe a properly designed ESRM program can prove its worth as an objective and meaningful force for positive change. The increased knowledge and understanding of E&S risks and impacts that ESRM programs provide allows leaders to make better decisions on individual transactions but across the board from a strategic perspective.

For those benefits to be fully realized though, industry participants need to lean in, engage, ask questions, and increase their understanding of how their clients or prospective clients are managing their E&S risks. If this happens at large, ESRM will come to be seen not as a toggle switch for automatic denials, but as a mechanism for identifying those companies that need more help than others when it comes to transitioning to more sustainable and equitable business practices.

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