How EU Climate Regs May Affect US Private Fund Managers

By **Trysha Daskam** (January 14, 2021)

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While tackling the COVID-19 pandemic and economic recovery currently dominates the policymaking and business agenda, the steady drumbeat around the financial risks associated with climate change has only been getting louder.

This drumbeat has now reached private equity and hedge fund managers, who are increasingly being pressured by a wide range of stakeholders — investors and regulators in particular — to consider climate risks in their investment decisions.

Last summer, U.S. investors managing $1 trillion in assets wrote[1] to Federal Reserve Chair Jerome Powell urging the central bank and other regulators to acknowledge that the climate crisis poses a systemic threat to financial markets and the real economy.

In early September, the U.S. Commodity Futures Trading Commission issued a report[2] that states climate change poses "serious emerging risks to the U.S. financial system," and called for U.S. regulators to "move urgently and decisively" to confront them.

And in December, the Net Zero Managers Initiative,[3] which includes 30 asset managers representing more than $9 trillion in assets, announced a commitment to work in collaboration with clients and other managers to achieve the goal of net zero greenhouse gas emissions by 2050 or sooner.

Some private fund managers may perceive that their typical investment horizons or investment strategy do not expose them to many of the longer-term risks associated with climate change, such as sea level rise and increases in severe weather events. Other private fund managers may believe that regulations on climate risks either won't apply to them or that compliance won't be necessary for many more years.

However, these managers may be severely underestimating the speed at which regulators and policymakers will take action, and the scale at which climate risks will affect their portfolios.

As compliance dates for environmental, social and governance regulations released by the European Commission draw closer, we expect to see a crescendo of climate-related activities — such as climate measurement, evaluation and scenario analyses — from Europe-based managers in the coming six to 12 months, with a possible knock-on effect in the U.S. over time.

These regulations will likely trigger inquiries from European investors, including pension funds, to U.S. managers requesting information on how climate risks are being managed and mitigated in investment decisions.

Private fund managers, even those that were early movers in addressing climate risks, now face an uphill climb to bring their portfolios, policies and processes in alignment with a growing list of regulations and investor demands.

European Regulation Is Coming

Europe has taken the lead globally on developing rules designed to green the financial system with the recent passage by the European Union of two landmark pieces of legislation.

One, known as the Sustainable Finance Disclosure Regulation,[4] is designed to inject more transparency into how the financial sector considers sustainability risks in investment decisions, and is expected to come into effect in March. A second, the Taxonomy Regulation,[5] establishes an EU-wide common language to identify to what extent economic activities can be considered environmentally sustainable.

While most U.S. private fund managers are not expected to be directly affected as regulated entities, the effect of both regulations is likely to bleed through to the U.S. in various ways. U.S. private fund managers with a Europe-based subsidiary may be affected by some or all elements of the EU regulation, while firms that market their funds in the EU will have certain obligations they will need to comply with.

There may be additional extraterritorial elements to these regulations over time, and there will be increasing pressure to align with best practices as firms in Europe work to come into compliance.

Asset Allocators Will Expect Detailed Climate Data

As climate-focused regulations take shape in Europe and elsewhere, managers are likely to face increasing data requests from asset allocators asking how climate risks are being accounted for in their portfolios.

We expect to see allocators and limited partners asking questions about greenhouse gas emissions, carbon footprinting, energy intensity and air travel policies, among other issues.

Moreover, we expect certain asset allocators will be subject to, or will voluntarily use, the Task Force on Climate-Related Financial Disclosure, or TCFD[6] reporting framework to evaluate the climate risk posed by their managers and their portfolio overall. Asset allocators that face regulatory reporting requirements will likely demand that their underlying managers provide investment-level, climate risk-related data.

Ultimately, a fund manager's ability to satisfy these requests for climate-related data may become a factor in determining whether the manager is able to retain an allocation, or allocations, especially in cases where investors are required to provide climate disclosures to comply with local regulations in the jurisdiction in which the investors are located.

U.S. Laying the Groundwork for National Climate Policy

After four years of backsliding on climate policy, the U.S. is set to formally rejoin the Paris Agreement when President-elect Joe Biden takes office. Biden and his team are widely expected to work on a climate action plan through a combination of legislation, regulation and executive action.

One policy that may attract bipartisan support is mandated climate risk disclosures for corporations, an idea that Michael Bloomberg enthusiastically supported in a recent op-ed,[7] writing how:

official U.S. support for the TCFD guidelines would serve to unify the global effort to measure climate risk, remove uncertainty about the direction of regulation, and enable the creation of a single system that is consistent across borders and industries.

But even in the absence of such a national plan, many U.S. states have pursued their own climate-related actions.

Steps Private Fund Managers Can Take Now to Prepare

As private fund managers begin to focus specifically on climate risks in their portfolios, we believe there are several steps they can take:

- Review your ESG policy to determine areas of alignment and consider how climate risks can be evaluated as part of the firm's approach to ESG.
- Don't rush to respond to data requests from asset allocators. Understand the scope of climate-related questions and the applicability of those questions to your investment strategy. It is important that managers not commit themselves to climate reporting or other standards that they cannot yet meet.
- Understand the climate-related organizations that are attracting investors' attention and their relevance to your firm. For example, the TCFD's priority areas (governance, strategy, risk management, metrics and targets) often serve as the framework for the climate-related questions investors may be asked.
- Remember that climate risk is also climate opportunity. There is the potential value-creation in addressing climate risks in a portfolio. Private fund managers are in a unique position to participate, given their growing share of ownership in the wider economy.

Like BlackRock Inc. CEO Larry Fink, we believe that climate risk is as an investment risk and will need to be treated as such. Private fund managers need to get to work.

Trysha Daskam is director and head of ESG strategy at Silver Regulatory Associates.

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[1] https://www.institutionalinvestor.com/article/b1mlk6gdzq7kx7/1-Trillion-Investor-Group-Demands-Climate-Action-From-Regulators.

[2] https://www.cftc.gov/PressRoom/PressReleases/8234-20.

[3] https://www.netzeroassetmanagers.org/press-release.

[4] https://eur-lex.europa.eu/eli/reg/2019/2088/oj.

[5] https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en.

[6] https://www.fsb-tcfd.org/.

[7] https://www.bloomberg.com/opinion/articles/2020-12-14/the-world-needs-biden-to-lead-on-climate-disclosure?sref=Lx0AgPZI.