Financial Cos. Must Address Climate Risk As Regulations Near

By **Bao Nguyen and Vartan Shadarevian** (January 11, 2022, 1:18 PM EST)

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In a November 2021 address to the headquarters of the Office of the Comptroller of the Currency, the acting comptroller, Michael Hsu, stated a desire to "move the climate conversation from the offices of scientists, policymakers, and regulators to bank boardrooms," laying out climate risk questions every bank board should be asking of themselves.

The remarks are a sign of the Biden administration's increased focus on climate change, which has made it a top priority across the government, and that U.S. financial regulators are now taking steps to translate broad policy priorities into concrete policies and initiatives.

From their public pronouncements and actions, it is becoming increasingly clear that regulators will address climate change issues through their authority to supervise the safety and soundness of financial institutions and preserve the stability of the financial system.

They will likely retool the supervisory framework used to assess risks and risk management, creating incentives for institutions to increase investments and activities in green businesses and industries and reduce their involvement in those that are carbon-centric.

From the regulators' standpoint, approaching the problem through the supervisory process, where there is great latitude for their exercise of judgment, is preferable both legally and reputationally to an approach that would have regulators mandate specific investments or activities for financial institutions to address climate change.

In an example of the supervisory approach, the New York Department of Financial Services in November issued guidance on managing climate-related financial risks for domestic insurers in the state.

To adjust to this emerging regulatory approach, financial institutions should consider instituting a sound risk management framework that takes into account the consequences of climate change.

Financial institutions should also evaluate the role of climate change in their policies, processes, personnel, management information systems, and quality control and assurance systems.

Under the Biden administration, financial regulators have repeatedly stressed the risks that climate change poses.

On May 20, 2021, President Joe Biden issued an executive order on climate-related financial risks,[1] which directed the secretary of the treasury, in her role as chair of the Financial Stability Oversight Council, to consider how to combat climate change, especially as it affects the financial sector. The order specifically cited the potential impact on the stability of the U.S. financial system.

In response to the executive order, FSOC issued a report that included concrete recommendations to help member agencies assess the financial risks of climate change, enhance climate-related data and disclosures, and build expertise to address climate change.

In addition, a White House report issued pursuant to the executive order aimed to

> usher in a new era where climate-related financial risks are thoroughly understood — where they are measured, disclosed, managed, and mitigated across the economy.

That sentiment has been echoed by key financial regulators. Federal Reserve Gov. Lael Brainard said in a speech that "climate change might be expected to increase financial system vulnerabilities" and noted that regulators should "ensure that the financial system is resilient to climate-related risks and well positioned for the transition to a sustainable economy."

Likewise, in U.S. Senate testimony, Hsu cited the safety and soundness implications of climate change for the banks the OCC supervises, noting that physical risks from climate change may affect financial assets and borrowers' creditworthiness.

Internal changes at the regulators also reflect the new orientation.

The OCC recently announced the appointment of the agency's first climate change risk officer, and the Fed created a Financial Stability Climate Committee to assess and address climate-related risks to financial stability.

Both agencies have also been working with regulators in other countries on these issues, including through the Network of Central Banks and Supervisors for Greening the Financial System, as well as the Basel Committee on Banking Supervision, which helps set prudential and regulatory standards globally.

Using supervisory authority will give regulators flexibility and help them avoid challenges to their actions.

From their public pronouncements and actions, it is becoming increasingly clear that regulators will leverage their supervisory authority to address climate change issues.

By focusing on risks to individual institutions and the financial system at large, regulators will be operating in an area where they have broad discretion to apply their judgment.

Under such an approach, regulators would adjust the supervisory framework and expectations to capture the financial and stability risks of climate change, many of which were outlined in a March 2021 Fed paper.

Those factors would lay the groundwork requiring financial institutions to:

- Assess the financial risks associated with the negative consequences of climate change, such as deteriorating public health; labor productivity; agricultural yields or public infrastructure; rising mortality rates; and weather-related property destruction;

- Implement a risk management framework to mitigate the financial risks of climate change, including reassessing asset values, changing the cost or availability of credit, or reconsidering the timing or reliability of cash flows; and

- Guard against the financial stability impacts of climate change by focusing on the risks of rare climate tail events that can amplify credit, liquidity and counterparty risks and challenge financial risk management in ways that are hard to predict.

If an institution's comprehensive risk management program fails to address the financial and stability risks of climate change, regulators can: (1) make exam findings, (2) cite matters requiring attention and/or violations, (3) lower supervisory ratings, or (4) require remedial actions.

Such supervisory actions could limit an institution's activities and increase the cost of operations. Ultimately, failure could be the basis of an enforcement action.

In addition, by linking climate change to risk management and financial stability, financial regulators will have a rationale for changing risk-based capital and liquidity rules to increase the cost of activities linked to carbon-heavy businesses and industries.

This supervisory-based approach is already being put into action.

The OCC recently released for public comment a draft set of principles designed to provide a potential framework for identifying and managing exposures to climate-related financial risks by OCC banks that have more than $100 billion in total consolidated assets.

As the OCC explained:

> Weaknesses in how banks identify, measure, monitor, and control potential climate-related financial risks could adversely affect banks' safety and soundness, as well as the overall financial system.

The principles and public feedback are the first steps toward formulating more formalized guidance and rules relating to climate-related financial risk in the future.

The OCC also issued a statement in support of FSOC's new Climate-Related Financial Risk Committee.

The other banking agencies have signaled they are likely to take similar steps.

For example, in a conference speech, Brainard stated:

> I anticipate it will be helpful to provide supervisory guidance for large banking institutions in their efforts to appropriately measure, monitor, and manage material climate-related risks, following the lead of a number of other countries.

Similarly, at a Center for American Progress event in December 2020, Federal Deposit Insurance Corp. board member Martin Gruenberg argued that

> regulators need to provide direction now to financial institutions to develop plans to identify, monitor, and manage the risks posed by climate change ... including through the use of stress tests.

We expect that, at the same time regulators use their supervisory powers, they will also likely offer positive incentives to induce financial institutions to engage in desired investments and activities.

For example, we expect them to issue guidance about green investments and activities that will receive positive consideration under the public welfare investment regulation[2] and the Community Reinvestment Act.[3]

There are long-standing precedents, for instance, for regulatory incentives to support wind power, solar power and energy conservation. Likewise, regulators — as they have done before — may encourage tax-advantaged investments in green businesses and industries.

Conclusion

Given the emerging supervisory approach to climate change, financial institutions should not rush to engage in climate-related investments and activities without first instituting a sound risk management framework that takes into account the consequences of climate change.

That may entail adjustments in an institution's risk culture and appetite to reflect its activities and investments related to climate change, and changes in risk systems to identify, measure, monitor and control the risks related to climate change.

Other steps institutions should consider include updates and changes to policies, processes, personnel — i.e., ensuring the appropriate expertise and level of staffing — management information systems, and quality control and assurance systems.

Just as important, institutions should evaluate the appropriateness of their governance structure for climate-related investments and activities, such as the assigned roles, responsibilities and processes for deciding the merits of specific climate-related investment or activity.

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[1] Executive Order 14030, "Climate-Related Financial Risk," May 20, 2021.

[2] 12 C.F.R. § 24.

[3] 12 U.S.C. §§ 2901-2908.