Financial Services Management

Green Risk-Based Capital Requirements

Cite
House Discussion Draft, Climate Crisis Financial Stability Act

Recommended Distribution:
Climate Risk, Policy, Legal, Government Relations

Websites:
https://financialservices.house.gov/uploadedfiles/climate_crisis_financial_stability_act.pdf

Impact Assessment

- Regulators would be required to impose high-cost penalty capital requirements on bank exposures to a wide range of entities with ties to fossil fuel. Already scarce funding would drop and capital-markets access could be problematic.
- A capital surcharge would also penalize a broader range of activities at large BHCs deemed to increase greenhouse-gas emissions. Defining when this occurs and where the surcharge should be set raises numerous methodological challenges.

Overview

House Democrats are considering legislation to mandate a punitive capital construct for bank and, in some cases, also to certain nonbank exposures to companies with fossil-fuel links. A still higher capital surcharge would also govern large-BHC activities that may increase greenhouse-gas emissions, a criterion bank regulators would have to define ahead of deciding what surcharge to set. This surcharge appears to contemplate a capital requirement on some of the so-called "Scope 3" climate exposures and thus could prove particularly problematic given ongoing methodological uncertainties in this area. At the least, the costs of doing business with sanctioned entities captured by the mandatory changes to risk-based capital weightings and the surcharge would be high and banks would thus likely sharply reduce all of their exposures in this sector. This might reduce climate risk but perhaps also increase the challenges affected companies already face obtaining funding for climate-risk remediation unless NBFIs and foreign banks expand their ability to support this sector.

Impact

Most of the focus on financial-sector climate risk in the U.S. has been with regard to public disclosures, now proceeding through a broader SEC initiative,[1] and stress testing.[2] However, capital charges expressly related to climate risk are a topic of extensive study by global regulators.[3] These discussions increase the interest of some U.S. legislators in proposing initiatives in this area, including the one outlined in this discussion draft.

As detailed below, the bill imposes a three-tier risk-based capital framework: initial penalty charges for exposures to brown entities related to transition risk, subsequent penalty charges for physical climate risk, and a surcharge designed to tax exposures captured under the risk-based charges along with a large BHC's own direct and indirect activities in which they engage that increase greenhouse-gas emissions.

The last requirement for what is deemed macroprudential risk is not specified in the bill, but the other charges are steep and would likely lead to sharp reductions in the direct loan, bond, and derivative exposures easiest to quantify and thus penalize.

The macroprudential charge is not only undefined in terms of amount, but also how greenhouse-gas emissions are to be measured. The approach is clearly intended to capture at least some Scope 3 exposures but definitions and qualifications here are particularly problematic. As a result, bank-regulatory standards could be inconsistent with developing research, any disclosures mandated by the SEC and international efforts.

The goal of this approach is clearly to enhance bank resilience and starve brown entities of the financing critics believe leads such entities to continue unabated activities that exacerbate climate risk. However, as has been the case with loans for lower-income borrowers, high capital charges may lead to sharp reductions in credit availability with unintended consequences. In this case, these could include significant reductions in the funds needed to remediate climate risk or invest in renewal energy and sudden inability to access the capital market unless NBFIs foreign banking organizations step in for U.S. banks. To the extent this happens, U.S. banks will experience adverse competitive consequences without the bill's desired reductions in climate risk unless funded or supported activities are able to handle the higher costs surely associated with reduced supply of lenders and underwriters in this sector.

What's Next

As noted, this bill has yet to be introduced. However, a hearing on it was held in conjunction with legislation also mandating a binding climate-risk stress test for large banks and nonbank financial companies. It is likely to be formally introduced

[1] See **GREEN6**, *Financial Services Management*, March 18, 2021.

[2] See **GREEN9**, *Financial Services Management*, August 26, 2021.

[3] See *Client Report* **GREEN3**, July 22, 2020.

when the House Financial Services Committee returns to action on climate risk. Although it stands low odds of final enactment, its provisions put still more pressure on U.S. regulators.

Analysis

A. Framework

Within eighteen months of enactment, the bill would require the banking agencies to incorporate climate risk into their risk-based capital requirements. This would be done by factoring "acute" transition risk, doing so by over time increasing risk weights to at least 150 percent for loans, bonds, and derivative exposures where borrowers or counterparties derive at least fifteen percent of revenue from an array of fossil-fuel activities. The bill also details how acute transition risk is to be considered by energy-sector and exposure type. At least every two years, the agencies would need to review these weightings and raise them.

Five years after enactment, the framework for acute-transition risk would be paired with one mandated for physical risk and any transition risks not previously accounted for. These additional capital charges could be based on any stress tests in this arena.

B. Coverage

These capital rules would apply to banks with over $1 billion in assets. Covered companies are insured depositories, DIHCs, and designated nonbanks but not BHCs.

C. Surcharge

BHCs are not covered by the risk-based capital standards cited above (perhaps a drafting error), but they would come under a "macroprudential climate-risk contribution surcharge" if they have assets over $100 billion. The same surcharge would apply to designated nonbanks based in both cases on a "climate-risk contribution" score based on the "totality" of greenhouse-gas emissions finance directly or indirectly. The bill does not specify what this surcharge would be.

D. Nonbank Designation

FSOC would also be directed to factor climate-risk contributions and exposures into the criteria used to designate systemic nonbank financial companies.

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