Financial Services Management

Climate-Risk Stress Testing

Cite

S. 1876/H.R. 3571, Climate Change Financial Risk Act of 2021

Recommended Distribution:

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Websites:

https://www.congress.gov/117/bills/s1876/BILLS-117s1876is.pdf,
https://www.congress.gov/117/bills/hr3571/BILLS-117hr3571ih.pdf

Impact Assessment

- Large financial companies would need relatively quickly to file climate-risk remediation plans that could lead the FRB to ban capital distributions. This would be costly to banks and problematic for nonbanks where there are often no capital requirements against which to assess penalties nor any primary regulators to agree with or enforce Fed standards. Although the bill seeks consistency in Fed climate stress test scenarios, remediation plans would surely vary dramatically as would the Fed's response to them. Subjectivity might undermine resulting risk-mitigation benefits.
- Large banks subject also to credit- and liquidity-risk stress testing could be deemed resilient under those standards but nonetheless subject to capital-distribution restrictions that then constrain other operations. This could increase bank resilience but also constrain financial intermediation and resulting economic growth. GSEs could be subject to Fed stress tests no matter the views of their primary regulator.
- Fed scenarios could prove de facto bans on "brown" exposures, accelerating financial-sector refusal to support the fossil-fuel sector. While this might enhance resilience and reduce global warming, it could also deprive brown firms of the funding needed to ensure a smooth renewable-energy transition.

Overview

Legislation from House and Senate Democrats would force the Federal Reserve quickly to implement mandatory stress testing for all large banking organizations and large nonbanks judged by asset size if they are principally engaged in finance. The measure attempts to address concerns about climate-risk uncertainties in areas such as data, models, and comparability by convening expert groups. The Fed would nonetheless need to do its best to quickly devise stress-test scenarios and then hold covered companies accountable under them. Sector climate resilience might well result, but test subjectivity, remediation variability, and sharp differences among covered-firm business models could undermine the legislation's goals as well as result in remaining climate risk and competitive disparities/regulatory-arbitrage opportunities.

Impact

This legislation begins with an expression of the sense of Congress not only about the dire nature of climate risk, but also the hazards it poses to financial institutions (here citing a 2020 paper from the CFTC[1]). The sense-of-Congress also calls for a consistent industry approach to measuring and projecting this risk, one that must be linked to capital adequacy when it comes to the largest banks. The bill laments the absence of climate risk in current FRB stress-testing standards, noting its importance not only to bank stability, but also to prevent systemic risk.

The bill thus mandates climate-risk stress testing for covered companies (see below) on a very rapid timeframe. The measure appears to recognize ongoing questions about the reliability, consistency, and predictive power of much climate-risk data; for example, it requires the Fed not only to convene an expert working group of lawyers and economists, but also to consult with the federal agencies directly involved in climate science. It also provides an introductory year in which stress-test results would not result in capital-distribution restrictions.

Even so, covered companies would come very quickly thereafter under a stress-test framework akin to the Fed's approach prior to the adoption of the stress capital buffer (SCB).[2] Under the earlier CCAR model, stress testing was not integrated with capital regulation *per se*, but an add-on to it designed to determine capital adequacy without necessarily recognizing all the other moving parts of operational, market, liquidity, and business risk. The bill may not have adopted the buffer approach because of its broad coverage, but the unilateral stress-test construct it instead has chosen likely presents a number of challenges beyond those related to scenario and model risk.

Perhaps the most striking of these is the extent to which capital would depend on a company's climate-risk remediation plans even though the degree to which the Fed could model, compare, and fit them into its own scenarios is at best uncertain in the near-to-mid-term. Further, the extent to which climate-stress testing would be integrated with the SCB or other stress tests is at best uncertain. The legislation's express mandates would make it difficult, if not impossible, simply to add climate-risk factors to current supervisory scenarios for the largest banks or establish clear rules for smaller banking organizations now performing only company-run stress tests. As noted, conflicts between final rules on capital adequacy would have broad strategic consequences not only for investors, but the extent to which banks could continue in other business lines without endangering broader capital adequacy.

The bill also mandates coverage in its stress-test construct for very large financial nonbanks regardless of whether they are otherwise under FRB regulation (which none at present are due to Trump Administration retraction of prior systemic

[1] See *Client Report* **GREEN4**, September 9, 2020.

[2] See **CAPITAL225**, *Financial Services Management*, March 11, 2020.

designations). FSOC might be able to reach undesignated nonbanks using its systemic activity-and-practice designation authority[3] – indeed, it may even come to do so. However, neither it nor the FRB can order undesignated nonbanks to take any actions. Primary regulators persuaded by FSOC or the Fed might agree to do so, but most nonbank financial companies have no over-arching prudential regulator and thus would come only under piecemeal climate-risk stress tests, if any.

The exception to these challenges for nonbanks is Fannie Mae and Freddie Mac. They are of course regulated, above the $250 billion coverage threshold, and financial and thus would come under these rules. As drafted, the bill would subject them to Fed stress tests even if their primary regulator, the Federal Housing Finance Agency, had a preferred approach if the Fed disagreed. Indeed, FHFA has recently sought comment on such an approach.[4] Because the GSEs are structurally different than large banks and have concentrated mortgage exposures, the Fed's approach and/or its preferred remediation requirements might not accurately reflect the GSEs' climate-risk exposure.

The legislation does not prescribe any of the terms of the Fed climate scenarios it requires other than to stipulate applicable temperature thresholds and the need to consider both likely and very likely physical and transition risks. However, the activities and exposures the Fed chooses to sanction could well create de facto restrictions on the ability of covered financial companies to lend to "brown" firms, support manufacturing of products that might be subject to transition risk, or provide mortgages in higher-risk areas even if the obligations otherwise pose no undue risk. Republicans have strongly opposed any Fed actions in this area partly on grounds that they are politically-driven credit allocation.[5] They are likely also to oppose this bill out of fears it would have like-kind effect. They are likely also to assert that the Fed has neither climate expertise nor an appropriate place in the climate-risk debate, preferring to see the central bank stick closely to its monetary- and regulatory-policy mission.

What's Next

H.R. 3571 was introduced on May 28 by Rep. Casten (D-IL) and four Democrats; Sen. Schatz (D-HI) and ten Democrats introduced S. 1876 on May 27. The House Financial Services Subcommittee on Consumer Protection held a hearing on the House bill on June 30. There has been no Senate Banking hearing on the legislation, but Democratic senators have strongly pressed Chairman Powell to institute climate-risk stress tests.[6] Similar pressure is also continuing in the House,[7] but legislative action via a committee vote this fall is also likely. Should

[3] See **SIFI35**, *Financial Services Management*, December 18, 2019.

[4] See **GSE-012121**, *GSE Activity Report*, January 21, 2021.

[5] See **ESG3**, *Financial Services Management*, December 1, 2020.

[6] See **FEDERALRESERVE63**, *Financial Services Management*, July 15, 2021.

[7] See **FEDERALRESERVE62**, *Financial Services Management*, July 14, 2021.

this prove favorable – as seems likely – the bill would then be referred to the House Energy & Commerce Committee, which would likely begin with its own hearings prior to action. As a result, full House consideration is not likely until 2022, should it come at all.

This measure comes in concert with an executive order (EO) from President Biden mandating rapid action on financial-sector climate risk.[8] The EO gives Treasury 180 days from its signing – i.e., until November 16 – to recommend actions to independent financial regulators such as the Fed. The principal focus of the order is on transparency, putting the greatest pressure on the SEC to act quickly following its request for views in this area.[9] Although Treasury's report will surely also address stress testing, it is likely to reflect the Fed's aversion to mandatory testing at this point as well as any links to capital adequacy.

Analysis

A. Definition

The term "climate-science leads" used below reflects the bill's definition which cites the heads of various federal agencies with direct climate-science responsibility. The Fed is given the discretion also to rely on other agencies.

Companies covered by the bill include a bank or nonbank with total assets of more than $250 billion and banks/nonbanks with over $100 billion in assets if the Board thinks this appropriate under factors detailed in the bill. Nonbanks are defined by reference to Dodd-Frank,[10] meaning those that are principally financial. “Surveyed" entities are nonbanks or BHCs with assets over $100 billion governed by the Fed not otherwise captured by the bill.

B. Stress Testing

The Fed is required to establish a Climate Risk Scenario Technical Development Group charged with developing and updating climate-risk scenarios and resulting financial risk. It is to make its work public and also provide advisory services to covered entities.

Within one year of enactment and in consultation with climate-science leads, the Fed would need to develop three climate-risk scenarios assuming an average temperature increase of 1.5 degrees Celsius above pre-industrial levels, a two-degree increase scenario, and likely and very likely temperature increases based on an array of factors. These scenarios would then be updated every three years. The bill also directs the Board to take international standards and various other developments into account to make its scenarios as consistent as possible. These scenarios would also need to reflect physical and transition risks (defined in the bill) across the global economy and reflect factors such as operational, liquidity, credit, and market risk.

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[8] See **GREEN8**, *Financial Services Management*, May 25, 2021.

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

[10] See **SYSTEMIC29**, *Financial Services Management*, July 13, 2010.

Once these scenarios are established, Fed stress testing under them would proceed every two years in consultation with any primary regulators and the climate-science leads. Covered entities would need to show capital sufficient to handle climate risk under all three of the scenarios described above. No adverse actions would result for the initial tests but results would be made public.

After the first exercise, covered companies would need to submit climate-risk remediation plans to the Fed based on the prior test's results, the company's planned capital policy with regard to climate risk, and its quantitative and qualitative targets for related on- and off-balance-sheet exposures remedying identified risks. The Fed may object to these plans if the company cannot maintain minimum capital under all requirements in the most adverse scenario or the plan is deemed unreasonable or otherwise deficient. In the event a plan is rejected, the covered company could make no capital distributions other than any required to comply with capital requirements.

C. Survey

In consultation with the OCC and FDIC, the Fed would also need to develop an "exploratory survey" to assess the extent to which surveyed companies can handle climate risk. Although this section references the definition above specifying very large companies, it also requires this assessment for agricultural and community banks and other financial institutions with significant climate-risk exposure judged by each of the Fed's three climate-risk scenarios. The survey would also need to assess remediation plans and resulting resilience.

Surveys would begin one year after stress testing; a public report on results and recommendations would be due eighteen months after the Fed concludes the survey. Surveys would then be required every two years.

Surveyed companies could not be subject to adverse reactions due to their reports, a provision that could complicate supervision in the event a regulator or examiner believed a firm's or group of firms' exposures was unsafe or unsound. The Board is not, however, limited with regard to enforcement actions discovered independent of survey results.

D. FSOC

The Council would be required to form a climate-risk committee looking at systemic climate risk, submitting a report on this and related questions one year after the initial Fed stress tests described above and each year thereafter.

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