# Climate Risk-Management Principles

**Cite**

OCC, Draft Principles for Climate-Related Financial Risk Management for Large Banks

**Recommended Distribution:**

Climate risk, Risk Management, Policy, Corporate Secretary, Legal, Government Relations, Community Relations, Social Policy

**Website:**

https://www.occ.gov/news-issuances/bulletins/2021/bulletin-2021-62a.pdf

## Impact Assessment

- National banks will need to restructure governance to ensure that climate-risk monitoring, and mitigation efforts quickly satisfy supervisory expectations.
- Although mandatory standards are near-term likely only for larger banks, examiners and stakeholders will surely seek like-kind governance and risk-mitigation from most banking organizations.
- The OCC for the first time proposes supervisory standards dealing not only with direct safety-and-soundness problems and known indirect risks (e.g., compliance, reputational). Now, it could also deem failure to address the economic-equality or racial-equity impact of a bank's financial climate risk also to be an action requiring remediation even in the absence of fair-lending violations or direct/indirect risk to the bank.
- Supervisory policy premised on equity and equality criteria would be an even more significant policy shift if also applied to other risk exposures.

## Overview

Issuing the first formal U.S. climate-risk proposal, the OCC is seeking comments on high-level risk-management principles to set the context for additional, more binding action governing larger U.S. banking organizations. Reflecting also FRB efforts likely soon to result in concrete proposals, the OCC emphasizes effective governance and the importance of redesigning current risk-management procedures, monitoring, validation, modelling, and data collection to reflect climate risk. The agency is also open to new instruments or programs that might mitigate climate risk and clearly intends quickly to move from principles to specific scenario-analysis requirements. All of these climate-risk policies and procedures would also need to address not only the direct and indirect risks banks are rapidly addressing, but also the impact of climate risk on vulnerable communities and low-and-moderate income (LMI) households, possibly requiring banks to take an affirmative role restoring environmental justice through their climate-risk management and mitigation programs along with corporate philanthropy and other social-policy operations.

## Impact

The OCC's draft principles advance the "whole-of-government" initiative launched by President Biden's climate-risk executive order in mid-2021 urging all agencies to take aggressive steps within the boundaries of their jurisdictions and knowledge to reduce physical and transition climate risk.[1] Following this order, the Financial Stability Oversight Council issued the report requested of it, confirming that climate risk poses an array of financial hazards that require immediate regulatory action.[2] However, the FSOC report also acknowledged that climate-risk financial data are uncertain and often inconsistent among financial institutions and their counterparties even as analytical methodologies to model or stress-test climate risk remain at an early stage.

While the OCC restates these conclusions, it nonetheless finds that climate risk is so pressing as to warrant immediate, more binding action by larger national banks to reduce financial climate risk where they can and to move as quickly as possible to develop data and the necessary analytical tools making possible user. Further, the OCC seems bent on holding boards and senior management accountable for rapid action to construct climate-risk protocols suitable to their own bank even as the broader state of regulatory, industry, and analytical efforts continues.

As in the President's order and FSOC report, the OCC's draft principles also adopt a new framework for considering financial climate risk: equality and equity. This environmental-justice focus has become a supervisory and governance factor because, the agency says, climate risk can disproportionately hurt vulnerable communities and "disadvantaged households." Banks are said not to be suitably mindful of these risks and thus will benefit from the additional guidance provided here, which, if finalized, would stipulate that large banks focus on environmental justice with the same vigor as on their own exposures even if the equality/equity implications of climate risk pose no direct risk of credit loss, operational failure, or legal liability.

How the OCC proceeds to implement this environmental-justice mission may become clearer as the inter-agency effort advances to rewrite CRA regulation. Acting Comptroller Hsu has withdrawn the OCC's controversial standards, CRA with the agencies now building out a proposal along lines previewed in 2020 by the Federal Reserve.[3] This adds environmental-justice actions to those for which a bank may be given CRA credit. This creates an incentive to act along lines addressed also in the OCC's draft principles, but CRA standards lack the immediate force of the specific supervisory requirements the OCC anticipates.

Although this is not clearly reflected in its risk principles, the OCC's questioning also indicates openness to new climate-risk mitigation programs or financial instruments. These have also been outlined in a recent CFTC report,[4] which focused on new derivatives and futures-market approaches to climate-risk hedging. National banks dominate U.S. derivative activities. To the extent the OCC favors them, this market could grow even more rapidly with still greater potential to limit the financial risks associated with climate change.

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1 See **GREEN8**, *Financial Services* Management, May 25, 2021.

2 See *Client Report* **GREEN11**, October 22, 2021.

3 See **CRA30**, *Financial Services Management*, October 13, 2020.

4 See *Client Report* **GREEN4**, September 9, 2020.

## What's Next

The OCC issued this proposal on December 16; comments are due by February 14. The next step for the OCC following review of comments will be supervisory guidance tailored to banks based on an array of risk characteristics. The FRB plans to watch comments on this carefully and work with the OCC also to advance inter-agency standards in 2022. The FDIC is likely to join this effort now that Chair McWilliams has resigned.

Although Members of Congress have sought tougher, faster U.S. standards with regard both to stress test[5] and risk-based capital,[6] it will be very difficult to enact these measures. As a result, Democrats will keep the pressure on the banking agencies to advance standards such as those likely to come from the OCC and/or FRB and FDIC, but not mandate them.

## Analysis

The high-level principles are targeted at banks with assets over $100 billion even though the OCC suggests that all banks take heed of them.

### *A. General Principles*

These reiterate the importance of risk management and the need for boards and senior management to ensure it with regard to climate-related financial risk. Boards would need to be able to demonstrate knowledge of both climate risk and actions the bank has taken to mitigate it, ensuring that resources, reporting lines, and other factors effectively advance this goal. The OCC stipulates that:

- climate-risk management may occur in separate structures or in existing risk-management operations;
- relevant climate-risk time horizons will evolve over time and risk management may thus consider issues beyond the bank's usual strategic-planning timeline;
- management should establish climate-specific policies, procedures, and limits to which the board holds it accountable and to which it holds other staff accountable;
- financial-risk exposures should be expressly factored into strategic planning as well as that related to finance, capital, and operations;
- consideration by the board and senior management must also be given to stakeholder interests, the bank's reputation, and the impact of climate risk on LMI and other vulnerable communities or households. The agency recognizes that accomplishing this will require an iterative process, noting also that climate-risk considerations should comport with roader strategic objectives; and
- public climate-risk statements should align with internal strategies.

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

[6] See **GREEN10**, *Financial Services Management*, August 27, 2021.

### B. *Risk-Management Principles*

Going beyond this broad framework, the high-level principles detail risk-management standards such as:

- Risk identification should be organization-wide and consider plausible scenarios over various time horizons.
- Material climate-risk measurement and monitoring should begin and reflect relevant metrics (e.g., risk appetite). The bank should also develop relevant risk indicators, governance escalator and related controls.
- Banks should deploy an array of risk-management tools detailed in the policy with a focus on climate risk.
- Data, reporting, and reporting procedures are also detailed, with banks told also to incorporate these procedures into overall internal processes.
- Although climate-risk modelling remains under development, banks must nonetheless begin to construct their own methodologies and incorporate results throughout the risk-management process.
- Scenario analysis should begin, with the OCC noting that scenario analyses are not akin to stress tests because of flexibility in areas such as desired timelines, but banks must nonetheless develop scenario analysis appropriate to their size, complexity, and likely risk, with banks told also to ensure that scenario analyses capture not only specific exposures, but also climate risk's possible structural and macroeconomic impact. Scenario analyses may also assist the bank in identifying its own data and methodology limitations. The guidance also specifies oversight, quality-control, and validation procedures, with results regularly communicated as appropriate throughout the bank.
- Boards and senior management are to go beyond the overall principles outlined above also to ensure that specific risk-management procedures suffice.

The OCC plans to elaborate on the many specific risks laid out in this proposal with regard to credit, financial risks (e.g., interest rates, modelling), operational, legal/compliance, (e.g., fair-lending risk if policies disproportionately affect certain communities), and other non-financial risks (e.g., to strategy, reputation).

### C. *Request for Feedback*

Comments are sought on the principles as a whole and on:

- applicability, e.g., the need to apply these standards to other banks;
- appropriate tailoring;
- challenges likely when these principles are incorporated into risk management;
- existing, successful risk-management techniques;
- how to determine materiality;
- relevant time horizons;
- possible risk-mitigation practices and/or financial instruments;
- the types of climate-risk reduction products banks now offer;
- how banks now determine climate risk’s equality and equity impact;
- current data and methodology in this area;
- changes to regulatory-reporting requirements; and
- current scenario-analysis practice and relevant OCC considerations.