Large-Bank Climate-Risk Principles

Cite

FRB, OCC, FDIC; Final Inter-Agency Guidance; Principles for Climate-Related Financial Risk Management for Large Financial Institutions

Recommended Distribution

Climate Risk, Credit Administration, Risk Management, Compliance, Policy, Legal, Government Relations

Website

https://www.govinfo.gov/content/pkg/FR-2023-10-30/pdf/2023-23844.pdf

Impact Assessment

- All banking organizations over $100 billion, including covered FBOs and large branches, will need to ensure exacting climate-risk management procedures and governance, including scenario analyses of extreme, plausible risks over an extended time horizon.
- There are no mandated capital or other climate-risk buffers, but risk evaluations and especially scenario analyses could lead to de facto requirements for some institutions, especially those with large portfolios of real-estate exposures where insurance is threatened or infrastructure found to be in harm's way.
- There is no barrier to doing business with fossil-fuel entities or other “brown” risks, but long-term scenario analyses in areas such as transition risk may still make it harder to extend credit or agree to other risk exposures.
- Requirements specific to LMI communities have been softened, but banks will need to take care to ensure that climate-risk mitigation has no discriminatory effect and make efforts to prudently serve these communities.
- In addition to new procedures related to credit risk, covered banks will also need to address climate-risk exposures related to liquidity, interest-rate, market, operational, and legal risks.
- Bank climate resilience could increase in concert with playing a reduced role in climate change.

Overview

The banking agencies have joined together to issue inter-agency climate-risk guidance based on proposed standards from the FDIC, OCC[1] and FRB.[2] Most notably, the new standards expressly cover banking organizations over $100

[1] See **GREEN12**, *Financial Services Management*, January 4, 2022.

[2] See **CLIMATE15**, *Financial Services Management*, December 22, 2022.

billion, including FBO branches, but are indicative of the new approach to climate risk the agencies expect at any banking organization with elevated climate-risk exposure. Smaller banks exempt from this guidance may not need to establish specific scenario analyses, but some may be called upon to develop these even as banks under the standards are required to build scenario analyses subject to board review addressing extreme risks over the bank's long-term horizon in light of climate change. Many banks will need to quickly build internal climate-risk capabilities and governance systems and more than a few will alter business practices. The agencies are at pains to stress that the new approach covers only the emerging and material financial risks specifically within their ambit and that there is no prohibition on doing business with any entity or sector.

Impact

Consistent with their overall rule on the role of guidance, the climate principles state that the guidance does not have the force and effect of law nor are any specific requirements set despite the detailed nature of the guidance's provisions. They also emphasize that the decision to seek comment on the agencies' various approaches does not create the presumption that the final standards are regulations subject to the Administrative Procedure Act. That said, banks subject to costly enforcement actions related to climate-risk practices may come to contest any such penalties on these legal grounds.

Although the guidance as noted below covers only banking organizations with assets over $100 billion, the principles state that all banking organizations may have similarly material risks. As a result, examiners may hold all banks to many of the principle's stipulated practices other than those requiring more analytical firepower than smaller banks are generally expected to maintain. Thus, with some exceptions, the new guidance is a statement for banks and parent companies in general, not just those expressly covered by it.

Although the agencies are at pains in both the guidance and the statements supporting finalization to emphasize that the principles deal only with financial risk, opponents countered that the agencies have significant authority to handle these without a new focus only on climate risk. The agencies defend their approach on grounds that they already have risk-focused guidance on other specific risks, that the guidance does not set climate policy, and that only safety-and-soundness considerations are addressed. Notably, some commenters urged the agencies not only to focus on climate risk, but also to use standards to fort a more rapid transformation to zero emissions. The agencies also declined to do so.

Another major criticism often heard from Republicans is that the standards direct credit allocation to "green" entities and away from fossil fuels.[3] The final statement reiterates that nothing in it opines on any class of credit risk or borrower solely on grounds of climate risk regardless of ability to repay. However, it is clear that ability to repay will need to be considered with regard to borrower or exposure climate-risk profile to ensure a bank is found to have appropriately managed climate financial risk.

3 See *Client Report* **CLIMATE16**, July 18, 2023.

Climate risk is defined to cover not just these high-profile credit exposures, but also liquidity risk due to sudden funding-market shifts, market risk due to unexpected defaults or valuation changes, operational risk due to infrastructure disruptions, and legal risk for reasons not made clear in the guidance. As a result, all aspects of risk management – not just those directly concerned with credit – will now need to ensure that climate risk is appropriately mitigated.

Despite concessions, the final guidance includes stringent new scenario-analysis standards that, while they note the need to adjust these to a bank's complexity, will likely require banks of almost all sizes and especially larger ones to undertake formidable climate-risk data gathering, analysis, projection, validation, governance, and risk-mitigation exercises. If results show significant vulnerabilities that cannot be handled via existing buffers, then banks would also need to undertake extensive risk-mitigation activities that could significantly alter exposures in areas deemed subject to physical or transition climate risk. Some homeowners, businesses, regions, and/or industries could find themselves affected by credit scarcity or cost while contractors focused on issues such as infrastructure resilience could be rewarded.

The guidance is in many ways very general, leaving it to banks to determine the scenarios they posit over any time period they think germane using methodologies and data the bank deemed sufficient. Examiners may have varying views on how covered entities are to undertake these scenario analyses, increasing legal risk but the lack of detail also leaves broad scope for innovation and institution-specific risk reduction.

What's Next

The FRB approved this guidance on October 24 by a 5-2 vote and the FDIC did the same on that date with a 3-2 proceeding. Acting Comptroller Hsu signaled his agency's action in conjunction with his vote supporting the FDIC's agreement. The standards are effective – the release says "available" – when published in the *Federal Register*.

Analysis

A. Scope

1. Covered Banks

These are those with over $100 billion in assets, including FBOs with over $100 billion in assets housed in U.S. operations, and branches and agencies on its own have assets over $100 billion.

The guidance includes no explicit tailoring to alter the intensity of expected climate-risk standards or examiner reviews based on a covered bank's size, but the standards do indicate that supervisors will judge adherence as they always do by taking complexity and other considerations into account. The standards also recognize that many large banks continue to develop climate-risk safeguards and indicate that examiners will be mindful of this along with the need to anticipate iterative implementation of these standards into different risk types and exposures.

2. Materiality

The final statement indicates that climate-risk must be managed consistent with other strategies to address emerging and material risks. As a result, no express materiality standards apply.

B. Governance

The final standards revise the proposals to better differentiate between board and management responsibilities, telling directors to review climate-risk exposures at a high level to ensure they are consistent with overall risk tolerances, protect risk-management and audit independence, assure that considerations are complete and fully forward looking even if this goes beyond traditional strategic parameters, and assess external communications to ensure that these are consistent with internal protocols and practices. The board is also expressly told to ensure that climate risk is expressly factored into capital planning and to "encourage" management to take heed of operational and legal risk.

Management is told to institute climate-risk specific policies, procedures, and limits to provide "detailed guidance" on the institution's risk profile. No climate-specific compensation standards are outlined, with the guidance stating that sound compensation plans appropriately reward all forms of effective risk management.

C. LMI-Community Considerations

Banks are told to consider their climate risks with an eye towards prudently continuing to serve these communities as well as the bank's overall market in the context of ensuring fair-lending and fair-housing compliance via targeted reviews.

D. Scenario and Related Analyses

Banks are to ensure that climate-risk inputs are derived from stakeholders across the institution and incorporate scenario analyses similar to those the Board has required of the very largest banks in a manner commensurate with the bank's likely risks based on extreme, but plausible scenarios. These scenario analyses are subject to management oversight as well as to validation-and-quality controls commensurate with the institution's risk. Results are to be communicated to the board and "all relevant" personnel along with enough information for these individuals to evaluate the test's conclusions.

E. Risk Management

Most other internal risk-management steps are recommended, not mandated, but management is told clearly to identify material climate risks throughout the organization using its own materiality definition supported by “appropriate” metrics and escalation protocols. Management is also told to develop effective data resources and related analytical and aggregation capabilities. Management is also to consider climate risk in the broader overall risk-management and -mitigation construct, with the guidance details. Notably, it instructs banks to ensure that their risk-mitigation activities, including with regard to operational risk, ensure that this does not result in discrimination on any protected basis without saying specifically how this is to be done.

Federal Financial Analytics, Inc.
2101 L Street, N.W., Suite 300, Washington, D.C. 20037
Phone: (202) 589-0880
E-mail: info@fedfin.com Website: www.fedfin.com