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FSOC Climate Report: 10 key takeaways for the banking sector

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The FSOC Climate Report views "climate-related financial risk as an emerging threat to the financial stability of the United States." Here are our 10 key takeaways on a critical step in what will be a long and complex journey.

10 key takeaways

1. U.S. financial regulators are in catch up mode

In a press call on the Climate Report,[1] an unnamed "senior administration official" stated, "Are we behind? Of course we are. This is the starting gun going off for the U.S. regulatory system."[2]

The Climate Report contains 35 recommendations for FSOC's member agencies. It is a framework for next steps and a call to action, but is deliberately short on the details of exactly what the next actions will be. In that respect, the Climate Report is more of a blueprint for building a foundation than the foundation itself.

FDIC Chairman Jelena McWilliams abstained from voting on the Climate Report because "in light of the complexity of these issues and the limited time to produce the report, FSOC has not had an adequate opportunity to conduct sufficient analysis, fully consider broader macro consequences, and thoroughly evaluate the impact of its recommendations."[3] As a result, she is of the view that the Climate Report is "premised on a number of conclusions that warrant more thorough examination."[4]

Not surprisingly, a fundamental building block of the Climate Report is for member agencies to boost their internal capabilities. Recommendation 1.3 states that "consistent with their budget processes and mandates, FSOC members should prioritize internal investments to expand their respective capacities to define, identify, measure, monitor, assess, and report on climate-related financial risks and their effects on financial stability. This should include investments in staffing, training, expertise, data, analytic and modeling methodologies, and monitoring."[5]

The Climate Report requires FSOC to create two new committees: one staff-level committee designed to coordinate the activities of the U.S. financial regulators, called the Climate-related Financial Risk Committee, and one of outside experts, called the Climate-related Financial Risk Advisory Committee. How these two new committees will interact with the existing committees at the U.S. financial regulators is unknown. In Exhibit A, we list out all of the committees at the U.S. financial regulators that are mentioned in the Climate Report.

2. There is a strong emphasis on working internationally

The Climate Report is replete with references to international collaboration and cooperation, signaling that the America First era of the Trump administration is behind us. Although not in the Climate Report itself, in the press call, the senior administration official indicated that the goal was not only to catch up, but to "put ourselves in a leadership role internationally, which is where we want to be and this is the way to do it."[6]

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3. FSOC's focus is on climate-related financial risk as an "emerging threat" to financial stability

The Climate Report notes that many businesses, including financial institutions, have historically "viewed climate change through a social responsibility lens, instead of a financial risk lens."[7] That lens is inconsistent with FSOC's statutory mandate, which is tightly linked to financial stability and the resiliency of the financial system. This mandate leads FSOC to focus on "climate-related financial risk." Despite the sense of urgency and need for prompt action sprinkled throughout the Climate Report, there is a sober assessment of the challenges ahead in properly assessing how climate change is creating risks to and opportunities for the banking sector. FSOC also "recognizes that climate change disproportionately affects financially vulnerable populations potentially including lower-income communities, communities of color, Native American communities, and other disadvantaged or underserved communities"[8] and links that observation to climate-related financial risk.

4. FSOC member agencies realize that consistent and reliable data is a huge challenge

The Climate Report calls out data as a critical impediment. "While significant data related to climate change already exists, there remain gaps in connecting the science of climate change to financial risk assessments and real-world economic impacts. The ability of regulators and supervisors to build this expertise will be important to quantifying and assessing climate-related financial risk."[9] In this respect, FSOC is acknowledging the common challenges in "measuring, monitoring, and mitigating"[10] climate-related financial risks, which the Financial Stability Board and Network of Central Banks and Supervisors for Greening the Financial System are working to solve.

The Climate Report notes the "critical importance of taking prompt action to improve the availability of data and measurement tools,"[11] and it devotes an entire chapter to data and the methods for obtaining it. Of the 30 recommendations, 12 mention data in one way or another. The focus is on all elements of data, including assessing what is an appropriate measurement, collecting data, interoperability of data, sharing data and the possibility of making some data public. More data exists with respect to public companies than privately held ones, and the quality of the data, which is typically not assured or audited, is in question. The banking sector should expect that it will be asked to support these efforts.

The Office of Financial Research's (OFR) work has revealed a need to assess what commercial and governmental datasets exist and what academic data hubs can provide. OFR is actively working to identify data gaps linking climate change and financial stability and how to close them. Recommendation 2.4 is that the OFR work in coordination with the newly formed Climate-related Financial Risk Committee to provide data services and analytical tools to "facilitate members' assessment of climate-related financial risks."[12]

5. Climate-related financial risk will be incorporated into risk management in the near term

The banking sector should expect a very near-term focus on how the risk from climate change, particularly credit risk, should be incorporated into overall risk management. New York and Washington states, for example, have issued guidance for banks on climate-related financial risks.

Acting Comptroller of the Currency Michael Hsu announced that the OCC is "especially focused on the safety and soundness risks to banks from climate change" and that he intends to start with "sound risk management."[13] He also said that the OCC is "developing high level climate risk management supervisory expectations for large banks" and that the OCC "hopes to issue framework guidance in the near future."[14] It is unclear whether the OCC risk governance framework would be issued as a proposal with the opportunity for the banking sector to comment.

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The Climate Report notes that "some FSOC members may face trade-offs between climate-related financial risk mitigation measures and their other mandated objectives. For example, enhanced climate-risk management could result in regulated institutions limiting products and services (e.g., lending and insurance) in regions subject to physical risks, but this could hinder other objectives related to low- and moderate-income community development. As a result, FSOC member agencies should consider approaches that will achieve both climate-related financial risk objectives while also achieving other relevant aspects of their mission."[15]

While FSOC mentions the possibility of pulling back banking products and services from some geographic regions, it does not touch the politically controversial topic of fair access. Fair access laws limit the ability of banks to pull back credit and other services to sectors of the economy based on political or social reasons. Issues related to fair access, especially in light of state laws like that in Texas, will be one of the elements of transition risk in the banking sector and is likely to remain highly controversial.

6. Scenario analysis is on the medium term horizon

It is clear from the Climate Report that FSOC has decided to lean into the international trend of scenario analysis as an "emerging tool"[16] for assessing the financial risk related to climate change. Scenario analysis conducted by non-U.S. regulators—including the Bank of England—is explicitly noted as an example from which U.S. financial regulators could learn. The Climate Report notes that each of the preliminary scenario analyses prepared by foreign central banks "has given the authorities, and the financial institutions themselves, a better understanding of the financial stability implications of climate risk as well as the degree of potential losses at individual institutions. The exercises also identified areas in need of improvement (e.g., translating climate scenarios into macro-financial outcomes, closing data gaps, and building expertise), and the authorities aim to work toward more sophisticated efforts in future….These efforts can inform similar work by FSOC members."[17]

It is clear that FSOC anticipates that scenario analysis will begin on an experimental basis. It is likely that the Federal Reserve and other prudential banking regulators will build up their own models for scenario analysis based upon learnings from the Bank of England's current exercise, which are expected to be made public in May 2022.

FSOC takes great care to distinguish scenario analysis from stress testing and to point out that, unlike stress testing, scenario analysis would use a long-term time frame and would not be linked to dividend payments or share repurchases. It is unclear the extent to which the development of scenario analysis will be developed as a supervisory tool or the extent to which it will be subject to proposals on which the banking sector has the ability to comment.

7. A call to add a climate component to capital risk weighting is conspicuously absent from the Climate Report

Some have called for placing higher risk weights on climate unfriendly assets and lower risk weights on climate friendly assets.[18] This point has been made by Graham Steele, the nominee to be Assistant Secretary of the Treasury for Financial Institutions, who has argued that "[r]isk weights could be increased for loans and investments in climate change-driving assets, as well as credit exposures to sectors that are vulnerable to the effects of climate change," [19] and by former Vice President Al Gore, who supports "[changing] banks' regulatory capital requirements…to incorporate climate change."[20] Had FSOC chosen to recommend climate-based risk weighting, it would have signaled a major shift from credit-based criteria toward social criteria in determining capital requirements.[21] We read this omission as signaling that U.S. financial regulators are not inclined to front run any Basel Committee consideration of this issue. As a result, we view any changes to the risk weighting of assets as a result of climate risks to be a much longer term project.

8. TCFD emerges as the preferred disclosure framework

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There are multiple existing frameworks for climate-related financial disclosures, but the Task Force on Climate-Related Financial Disclosure (TCFD) framework emerges as an FSOC favorite and the framework most likely to dominate recommended and potential mandatory disclosures as they develop.

Over 1,650 companies have provided TCFD disclosure to date. Institutional investors have requested their investee committees use the TCFD framework. SEC Commissioners in public statements have mentioned TCFD as a leading climate disclosure framework, hinting that the SEC's forthcoming proposed rule on climate disclosures may draw heavily from this investor-endorsed framework. The UK and New Zealand will mandate TCFD disclosures by 2025 and 2023, while several other governments and numerous central banks, supervisors and regulators have formally expressed support for TCFD's recommendations.

TCFD's framework consists of four disclosure pillars: governance, strategy, risk management and metrics & targets. The strategy pillar draws on climate scenario analysis. The metrics & targets pillar elicits disclosure of the actual climate data and goals a company has collected or aims to achieve. Both pillars rely on data quality and availability.

9. Enhanced and standardized disclosure for all FSOC member agencies, not just for the SEC

A great deal of attention has been focused recently on what the SEC's forthcoming proposed rule on public company climate disclosure will require. SEC Chair Gensler and SEC staff have been actively discussing their views in speeches and testimony. As a result, there is nothing new in the Climate Report with respect to the SEC, proposed public company disclosures and ESG fund disclosures.

What is new, however, is that FSOC is focused on enhancing required public disclosures through all of its member agencies, not just the SEC. The Climate Report calls upon all member agencies to "promote consistent, comparable, and decision-useful disclosures that allow investors and financial institutions to take climate-related financial risks into account in their investment and lending decisions."[22] The Climate Report asks each member agency to review its existing required disclosures, in regulation and guidance, and assess whether different or enhanced disclosure is needed. Bank regulatory reports including the FR Y-14 and Call Reports are explicitly mentioned. Any such changes, like the forthcoming SEC proposed rule, would be subject to full notice and comment under the Administrative Procedure Act.

10. CFRAC will bring an unprecedented reliance on scientists and other external experts into FSOC

The Climate Report states that FSOC will create a Climate-related Financial Risk Advisory Committee, which will include "climate science experts; non-governmental research institutions; academia; the financial services industry; commercial businesses; consumer, investor, environmental, and labor groups; government agencies with climate expertise; and other stakeholders as appropriate."[23] This committee will bring an entirely new set of stakeholders into the FSOC orbit. It is an indication that FSOC is approaching climate change from an entirely different angle than it has any other previous task and that it expects a broader level of collaboration than has been seen before with actors outside the financial sector in addressing the financial risks posed by climate change.

Exhibit A: List of U.S. based climate committees and working groups (as defined in the Climate Report)

1. Newly announced climate committees in the FSOC report

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Climate-related Financial Risk Committee (CFRC): A staff-level committee to be formed 60 days after the Climate Report was released. The committee will "identify priority areas for assessing and mitigating climate-related risks to the financial system" and it will serve as a coordinating body to facilitate communication across FSOC members and interested parties.[24]

Climate-related Financial Risk Advisory Committee (CFRAC): This committee will report to the CFRC and will help FSOC gather information on and analysis of climate-related financial risks from a broad array of stakeholders.[25]

2. Already existing climate-focused committees and working groups

CFPB Climate Working Group: Group that assesses the impact of climate change on consumer financial well-being and on the markets for consumer financial products and services.[26]

Climate and Natural Disaster Risk Working Group: FHFA working group that aims to improve FHFA's understanding of climate and natural disaster risks and their impacts; review the regulated entities' risk management approaches; and ensure they continue to operate in a safe and sound manner.[27]

Climate Financial Risk Working Group: A NCUA working group with the goal of further incorporating climate-related financial risks into the agency's risk monitoring framework.[28]

Climate-Related Market Risk Subcommittee (Climate Subcommittee) of the Market Risk Advisory Committee (MRAC): The CFTC's climate-related financial risk subcommittee that issued a report on September 9, 2020, entitled *Managing Climate Risk in the U.S. Financial System*, available here.[29]

Energy and Environmental Markets Advisory Committee (EEMAC): A CFTC federal advisory committee.[30]

FHFA ESG Working Group: Group that works to coordinate FHFA's ESG efforts.[31]

Financial Stability Climate Committee (FSCC) and **Supervision Climate Committee:** FRB subcommittees that work to bring together senior staff from the FRB and the Reserve Banks on climate-related issues.[32]

National Risk Committee (NRC): An OCC subcommittee which monitors systemic and supervision risks facing the federal banking system receives quarterly briefings on climate-related financial risk to ensure that the risk is assessed appropriately under the agency's risk framework.[33]

- **Climate Risk Implementation Committee:** Formed by the NRC, this committee serves to identify weather and climate-related financial risks to OCC supervised institutions and provide recommendations to senior OCC leadership.

System Climate Network: An FRB working group formed to collaborate and develop capacity to engage on the topic of the financial risks from climate change across the Federal Reserve System.[34]

3. Committees and working groups incorporating climate

FDIC Regional Risk Committees (RRC): The FDIC has regularly assessed environmental risk as part of the semiannual RRC process since its inception in 2006 and has performed research on the potential implications of climate-related financial risks.[35]

FSOC Data Committee: Part of the pilot program OFR has initiated to serve as a climate data hub with another FSOC member; OFR has opened data discussions through this committee.[36]

Corporation Finance Section of the North American Securities Administration Association (NASAA): This committee will monitor and respond to federal and state securities law developments regarding ESG issues in response to state regulators' increased focus on climate change.[37]

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[1] Financial Stability Oversight Council, *Report on Climate-Related Financial Risk*, (2021). FSOC Report on Climate-Related Financial Risk (treasury.gov)

[2] Alexander C. Kaufman, *Climate Poses Many Threats To U.S. Financial System & Natural Gas May Be Major Risk*, Huffington Post (October 22, 2021). Climate Poses Many Threats To U.S. Financial System & Natural Gas May Be Major Risk | HuffPost Impact

[3] Jelena McWilliams, Chair, FDIC. Statement at the Financial Stability Oversight Council Meeting, Oct. 21, 2021. FDIC: Speeches & Testimony - 10/21/2021 - Statement by FDIC Chairman Jelena McWilliams at the Financial Stability Oversight Council Meeting

[4] *Ibid*.

[5] Financial Stability Oversight Council, *supra* note 1, at 5.

[6] Kaufman, *supra* note 2.

[7] Financial Stability Oversight Council, *supra* note 1, at 57.

[8] *Id*. at 120.

[9] *Id*. at 23.

[10] *Id*. at 47.

[11] *Id*. at 3.

[12] *Id*. at 7.

[13] Michael Hsu, Acting Comptroller of the Currency, OCC. Statement on FSOC Climate Change Report, Oct. 21, 2021. Statement by the Acting Comptroller of the Currency on FSOC Climate Change Report | OCC (treas.gov)

[14] *Ibid*.

[15] Financial Stability Oversight Council, *supra* note 1, at 23-24.

[16] *Id*. at 89.

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[17] *Id*. at 97.

[18] Barr, Jackson and Tahyar, Financial Regulation: Law and Policy 336-7 (3rd ed. 2021).

[19] Graham Steele, *Confronting the "Climate Lehman Moment": The Case for Macroprudential Climate Regulation*, 30 Cornell J. L. & Pub. Pol'y 109, 145 (2020).

[20] Harriet Agnew et al., *Al Gore urges overhaul of global finance to cut greenhouse gases*, Financial Times (Oct. 24, 2021). Al Gore urges overhaul of global finance to cut greenhouse gases | Financial Times (ft.com)

[21] Barr, Jackson and Tahyer, *supra* note 18.

[22] Financial Stability Oversight Council, *supra* note 1, at 3-4.

[23] *Id*. at 5.

[24] *Id*. at 118.

[25] *Id*. at 119.

[26] *Id*. at 38.

[27] *Id*. at 37.

[28] *Id*. at 30.

[29] *Id*. at 35.

[30] *Id*. at 36.

[31] *Id*. at 37.

[32] *Id*. at 28.

[33] *Id*. at 30.

[34] *Id*. at 29.

[35] *Id*. at 28.

[36] *Id*. at 39.

[37] *Id*. at 36.

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