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Federal Banking Agencies Issue Final Principles for Climate-Related Financial Risk Management

By Robert C. Azarow, James P. Bergin, Amber A. Hay, Teresa L. Johnson, Michael A. Mancusi, Erik Walsh and Michael Treves*

In this article, the authors provide an overview of the final principles for climate-related financial risks management for large financial institutions issued recently by the federal banking agencies.

The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively, the FBAs) have issued final interagency "Principles for Climate-Related Financial Risk Management for Large Financial Institutions" (the Principles).¹ Notably, after the Principles were proposed in 2021 and 2022, the FBAs received industry comments and criticisms from politicians – and even certain Federal Reserve Governors – about the burden in adopting these Principles and the perception that the FBAs were acting beyond their mandate, effectively as "climate policymakers."

This article provides an overview of the final Principles, changes from the draft Principles, and notable criticisms that reflect the ongoing debate about the role of the FBAs in influencing financial institutions' climate-related risk appetites and risk management practices.

The final Principles remain largely the same as the draft Principles. This is a strong message from the FBAs that they expect large financial institutions to adopt risk-based, climate-related financial risk management procedures. Although the Principles only apply to financial institutions with over US\$100 billion in consolidated assets, it is possible that, formally or informally, these Principles eventually will form the basis of supervisory expectations for financial institutions of all sizes, and therefore these Principles should be of interest to the entire industry.

FINAL CLIMATE-RELATED RISK MANAGEMENT PRINCIPLES

The final Principles reiterate the FBAs' view that financial institutions are likely to be affected by both the physical risks and transition risks associated

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¹ https://www.govinfo.gov/content/pkg/FR-2023-10-30/pdf/2023-23844.pdf.

with climate change, which can manifest as traditional micro-prudential risks, such as credit, market, liquidity, operational, and legal risks. To address these risks, the Principles cover six areas: governance; policies, procedures and limits; strategic planning; risk management; data, risk management and reporting; and scenario analysis. The Principles also include a section on "management of risk areas," which describes how climate-related financial risk can be addressed in various traditional risk categories.

GOVERNANCE

- The Principles provide that financial institution boards of directors and management should demonstrate sufficient knowledge of the effects of climate-related financial risks on the institution and its risk profile.
- The FBAs expect the board:
 - To oversee the institution's risk-taking activities;
 - To hold management accountable for adhering to the risk management framework; and
 - To allocate appropriate resources to support climate-related financial risk management.
- Management should:
 - Provide the board with sufficient information for the board to make sound, well-informed decisions relating to material climaterelated financial risks to the institution;
 - Implement the institution's policies in accordance with the board's strategic direction; and
 - Execute the institution's overall strategic plan and risk management framework, including overseeing the development and implementation of process to identify and manage material climate-related financial risk.

POLICIES, PROCEDURES AND LIMITS

- Management should incorporate material climate-related financial risks into policies, procedures, and limits to provide detailed guidance on the financial institution's approach to these risks in line with the strategy and risk appetite set by the board.
- The Principles establish that policies, procedures, and limits should be modified to reflect the distinctive characteristics of climate-related financial risks and changes to the financial institution's operating environment or activities.

STRATEGIC PLANNING

- The board should take into account material climate-related financial risk exposures when setting and monitoring the institution's overall business strategy and risk appetite.
- The board also should consider climate-related financial risk when overseeing management's implementation of capital plans, and it should assess the potential impact of material climate-related financial risk exposures on the institution's financial condition, operations, and business objectives over various time horizons.
- A financial institution should consider the impact of its climate-related risk management practices on low- and moderate-income (LMI) and other underserved communities and their access to financial products and services, consistent with the institution's obligations under applicable consumer protection laws.
- Institutions that publicly communicate their climate-related strategies should ensure that any public statements about strategies and commitments are consistent with the institution's internal strategies, risk appetite statements, and risk management framework.

RISK MANAGEMENT

- Management should oversee the development and implementation of processes to identify, measure, monitor, and control exposures to climate-related financial risks within the financial institution's existing risk management framework.
- This includes the development of processes to measure and monitor material climate-related financial risks and communicate and report the materiality of those risks to internal stakeholders.

DATA, RISK MANAGEMENT AND REPORTING

- According to the Principles, sound climate-related financial risk management depends on the availability of timely, accurate, consistent, complete, and relevant data. Accordingly, the Principles expect that management will incorporate climate-related financial risk information into internal reporting, monitoring, and escalation processes to facilitate timely and sound decision-making across the financial institution.
- The Principles suggest that because available data, risk measurement tools, modeling methodologies, and reporting practices continue to evolve, management should monitor developments and incorporate them into climate-related financial risk management as warranted.

SCENARIO ANALYSIS

- Climate-related scenario analyses are used to conduct a forward-looking assessment of the potential impact on a financial institution of changes in the economy, changes in the financial system, or the distribution of physical hazards resulting from climate-related financial risks.
- Management should develop and implement a climate-related scenario analysis framework in a manner commensurate to the financial institution's size, complexity, business activity, and risk profile.
- The results should be clearly and regularly communicated to the board and all relevant individuals within the financial institution, including an appropriate level of information necessary to effectively convey the assumptions, limitations, and uncertainty of results.

MANAGEMENT OF RISK AREAS

- Management should consider and incorporate climate-related financial risks when identifying and mitigating all types of risk, such as credit, liquidity, operational, legal, and compliance risks.
- Regarding credit risk, the Principles state that management should consider climate-related financial risks as part of the underwriting and ongoing monitoring of portfolios, as well as in determining the institution's credit risk appetite.
- With respect to liquidity risk, the Principles provide that management should assess whether climate-related financial risks could affect the institution's liquidity position and, if so, incorporate those risks into their liquidity management practices and liquidity buffers.

CHANGES FROM THE PROPOSED PRINCIPLES

The final Principles contain several specific changes aimed at the feedback the FBAs received in comments to the draft Principles, including:

- Explicit statement that the Principles do not prohibit or discourage financial institutions from providing banking services to customers of any specific class or type, as permitted by law or regulation. The Principles state, "the decision regarding whether to make a loan or to open, close, or maintain an account rests with the financial institution, so long as the financial institution complies with applicable laws and regulations."
- Clarification that the Principles apply to foreign banking organizations with combined U.S. operations of greater than US\$100 billion, as well as any branch or agency of a foreign banking organization that

individually has total assets of greater than US\$100 billion.

- Clarification that the FBAs expect financial institutions to manage climate-related financial risks in a manner that will allow them to continue to prudently meet the financial services needs of their communities, including LMI and other underserved consumers and communities, and to ensure compliance with fair housing and fair lending laws.
- The Federal Reserve's proposed Principles suggested that boards consider whether climate-related financial risks may warrant changes to compensation policies. The final Principles remove this specific suggestion, yet the FBAs emphasize that "sound compensation programs [should] continue to be important to promote sound risk management and to protect the safety and soundness of financial institutions," citing existing guidance on compensation.

FEDERAL RESERVE GOVERNOR BOWMAN'S CRITICISMS OF THE FINAL PRINCIPLES

Federal Reserve Governor Michelle Bowman issued a dissenting statement to the Board of Governor's approval of the final Principles, stating that they "will create confusion about supervisory expectations and will result in increased compliance cost and burden without commensurate improvement to the safety and soundness of financial institutions or to the financial stability of the United States."²

Governor Bowman maintains that financial institutions of all sizes have long been expected to manage risks associated with their activities, including climate-related financial risks, and yet the Principles do not explain why unique treatment of climate risks is warranted. She indicates that the Principles could distract attention and resources from the core risks of credit risk, interest rate risk, and liquidity risk.

Governor Bowman also asserts that potential costs on banks could discourage banks from lending and providing financial services to certain industries and communities, forcing them to seek credit outside of the banking system from non-banking lenders and resulting in decreasing or eliminating access to financial services and increasing the cost of credit to these industries and communities.

Governor Bowman further worries that examiners will feel pressure to apply the Principles to smaller financial institutions.

 $^{^{\}mathbf{2}} \ \text{https://www.federal reserve.gov/newsevents/pressreleases/bowman-statement-20231024b.} \ \text{htm.}$

CONCLUSION

- While the Principles provide only guidance on the management of climate-related financial risks, the FBAs will expect financial institutions with over US\$100 billion in consolidated assets to consider the Principles as they develop a program to manage climate-related financial risks. Large financial institutions should keep these expectations in mind as they also gear up for the increased capital and resolution planning requirements issued by the FBAs.
- While the Principles are intended for financial institutions with over US\$100 billion in consolidated assets, financial institutions of all sizes should be familiar with them and consider making a risk-based determination on whether to implement some or all of the guidance, where appropriate and reasonable. Regardless of size, if a financial institution determines that climate risk, whether physical risk or transition risk, may be material to the institution, then adding climate risk to the institution's overall risk assessment and risk appetite would be warranted.
- Governance is key. At this early stage, the FBAs are likely to be primarily focused on whether the institution's governance framework facilitates effective climate-related risk assessments, management, and reporting to the board, rather than scrutinizing specific climate-related risk analyses and decisions. Financial institutions should consider assigning to one or more board committees the responsibility of defining the institution's climate risk appetite and assessing climate-related risk, opportunities, strategies, and risk mitigation plans, as well as ensuring that the board committees are receiving adequate information to perform these missions.
- The FBAs, like the U.S. Securities and Exchange Commission (SEC), are focused on potential misleading statements about institutions' climate-related statements. In response to public comments, the FBAs note that "when financial institutions engage in public communications of their climate-related strategies, boards of directors and management should confirm that any public statements about their financial institutions' climate-related strategies and commitments are consistent with their internal strategies, risk appetite statements, and risk management frameworks." This is the same message the SEC has reinforced through several enforcement actions against financial institutions accused of "greenwashing." Also, the SEC's proposed regulations on climate risk disclosure, expected to be finalized soon, would apply to SEC registered community banks as well as large financial institutions.

CLIMATE-RELATED FINANCIAL RISK MANAGEMENT

All financial institutions should ensure that material climate-related statements are adequately verified before publication, as government agencies – and plaintiffs' lawyers – are scrutinizing these statements closely.