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Federal Banking Interagency Guidance on Climate-Related Financial Risk Management for Large Financial Institutions

Final Principles Substantively Similar to Draft Principles

SUMMARY

On October 24, 2023, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (together, the "*Agencies*") jointly issued Principles for Climate-Related Financial Risk Management for Large Financial Institutions ("*Principles*") (Federal Reserve Governors Bowman and Waller, FDIC Vice Chairman Hill, and FDIC Director McKernan dissenting).[1] The Principles are substantively similar to the draft principles issued individually by the Agencies in 2021 and 2022,[2] but include targeted changes and clarifications to address commenter feedback. The Principles apply to regulated financial institutions with $100 billion or more in total consolidated assets.

The Principles cover six areas: (1) governance; (2) policies, procedures, and limits; (3) strategic planning; (4) risk management; (5) data, risk measurement, and reporting; and (6) scenario analysis. In addition, they describe how climate-related financial risks can be addressed in the management of six traditional risk areas: (1) credit risk; (2) liquidity risk; (3) other financial risk; (4) operational risk; (5) legal and compliance risk; and (6) other nonfinancial risk. Our publication, dated December 21, 2021, discusses key aspects of the OCC's draft principles.

The Principles are "intended to support efforts by financial institutions to focus on key aspects of climate-related financial risk management" and designed to help boards of directors and management "make progress toward incorporating climate-related financial risks into risk management frameworks in a manner consistent with safe and sound practices."[3]

In a statement accompanying the Principles, Federal Reserve Vice Chair for Supervision Barr stated that the guidance "provides clarity to the largest firms about how they should approach climate-related financial risk management."[4] Federal Reserve Governor Bowman, however, expressed concerns that the guidance "will create confusion about supervisory expectations and will result in increased compliance cost and burden without a commensurate improvement to the safety and soundness of financial institutions or to the financial stability of the United States."[5] Federal Reserve Governor Waller, FDIC Vice Chairman Hill, and FDIC Director McKernan also expressed concerns with the Agencies' treatment of climate-related financial risk relative to other risks that financial institutions face.[6]

KEY CHANGES AND CLARIFICATIONS

A. APPLICABILITY

Although the Agencies note that all financial institutions, regardless of size, may have material exposures to climate-related financial risks, the Principles apply to financial institutions with $100 billion or more in total consolidated assets.[7] The term "financial institution" includes national banks, Federal savings associations, U.S. branches and agencies of foreign banks, state nonmember banks, state savings associations, state member banks, bank holding companies, savings and loan holding companies, intermediate holding companies, foreign banking organizations ("*FBOs*") with respect to their U.S. operations, and non-bank systemically important financial institutions supervised by the Federal Reserve.[8]

In response to commenters' request for clarification regarding the draft principles' application to FBOs operating in the United States, the Principles clarify that they are applicable to (1) an FBO with combined U.S. operations of $100 billion or more in total consolidated assets and (2) any branch or agency of an FBO that individually has $100 billion or more in total consolidated assets.[9]

In his statement accompanying the Principles, CFPB Director Chopra (a member of the FDIC Board) suggested that regulators "should provide more tools and guidance to small banks that are grappling with climate-related risks, as well."[10]

B. AUTHORITY

The Principles do not incorporate suggestions from commenters requesting changes to the draft principles that "extend beyond the agencies' statutory mandates relating to safety and soundness," such as "suggestions that the agencies promote a transition to a lower carbon economy."[11] In his statement accompanying the Principles, Federal Reserve Chair Powell emphasized that the Principles are "squarely focused on prudent and appropriate risk management" and that the "Federal Reserve is not and will not be a 'climate policymaker.'"[12] In addition, he noted that decisions about policies to address climate change "must be made by the elected branches of government."[13] Similarly, Acting Comptroller of the Currency

Hsu noted that the Principles are "focused exclusively on risk management" and that they "recognize and respect that industrial policy and climate policy are outside of the scope of bank safety and soundness."[14]

Consistent with those statements, the Principles include new language clarifying that they "neither prohibit nor discourage financial institutions from providing banking services to customers of any specific class or type, as permitted by law or regulation" and that 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."[15]

C. GENERAL PRINCIPLES

The Principles also include the following targeted changes and clarifications in response to commenters:

- ***Roles of Board and Management*****:** In response to requests from commenters, the Principles further distinguish between the responsibilities of the board of directors and those of management, clarifying the role of the board in overseeing a financial institution's risk-taking activities and the role of management in executing the strategic plan and risk management framework. For example, the Principles clarify that the role of the board is to "direct management to provide timely, accurate, and well-organized information to permit the board to oversee the measurement and management of climate-related financial risks," whereas the responsibilities of management include "implementing the financial institution's policies in accordance with board's strategic direction and executing the financial institution's overall strategic plan and risk management framework."[16] The Principles also provide that, if weaknesses or gaps in climate-related financial risk management are identified—or if the information provided is incomplete—the board should "challenge management's assessments and recommendations."[17]
- ***Compensation Policies*****:** Although the Federal Reserve's draft principles included a provision related to financial institutions' compensation policies,[18] the Principles do not address compensation policies in light of the Agencies' existing guidelines and guidance on compensation, as well as feedback from commenters that incorporating climate-related financial risks into compensation policies would be overly prescriptive.[19]
- ***Materiality*****:** The Principles clarify that management should incorporate climate-related financial risks into their risk management frameworks "where those risks are material."[20] Although several commenters requested clarification regarding how financial institutions should determine whether climate-related financial risks are material—and some commenters requested clarification that financial institutions have the flexibility to make their own materiality determinations or clarification that materiality in the context of the guidance is distinguished from the concept of materiality in securities laws[21]—the Principles do not provide additional guidance in this respect. The Principles retain the guidance in the draft principles that financial institutions with sound risk management "employ a comprehensive process to identify emerging and material risks related to the financial institution's business activities."[22] The Agencies note that these processes should be "consistent with methods used to identify other types of emerging and material risks."[23]
- ***Underserved Consumers and Communities*****:** In response to feedback from commenters regarding the "potential unintended consequences of financial institutions' climate risk management strategies on low- and moderate-income and other underserved consumers and communities,"[24] the Principles provide that a financial institution's board should "encourage management to consider the impact that the financial institution's strategies to mitigate climate-related financial risks could have on [low- and moderate-income] and other underserved communities and their access to financial products and services, consistent with the financial

institution's obligations under applicable consumer protection laws."[25] In addition, as an example of how climate-related financial risk may be addressed in legal and compliance risk, the Principles added language noting that management should "ensure[] that fair lending monitoring programs review whether and how the financial institution's risk mitigation measures potentially discriminate against consumers on a prohibited basis, such as race, color, or national origin."[26]

OBSERVATIONS AND IMPLICATIONS

The Principles reflect a continued focus by financial regulators on climate-related financial risk. Following President Biden's May 2021 executive order on climate-related financial risk,[27] the Financial Stability Oversight Council issued a wide-ranging report on the topic in Oct. 2021 (see our publication, dated November 2, 2021)[28] and established a staff-level Climate-related Financial Risk Committee ("*CFRC*") in Oct. 2022.[29] The CFRC issued its first progress report on interagency efforts related to climate-related financial risk in July 2023, which noted that the Council and its member agencies "continue to view climate-related financial risk as a key priority and will advance the recommendations of the [Oct. 2021 FSOC report]."[30] Financial institutions should continue to closely monitor further actions by the Agencies and other financial regulators. For example, the Securities and Exchange Commission is in the process of finalizing its climate disclosure rules.[31] In addition, the Federal Reserve anticipates publishing insights gained from its pilot climate scenario analysis exercise toward the end of this year.[32]

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ENDNOTES

[1] *See* Federal Reserve, FDIC, OCC, Principles for Climate-Related Financial Risk Management for Large Financial Institutions (Oct. 24, 2023), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20231024b1.pdf.

[2] *See* OCC, Principles for Climate-Related Financial Risk Management for Large Banks (Dec. 16, 2021), *available at* https://www.occ.treas.gov/news-issuances/news-releases/2021/nr-occ-2021-138a.pdf; FDIC, Statement of Principles for Climate-Related Financial Risk Management for Large Financial Institutions, 87 Fed. Reg. 19,507 (Apr. 4, 2022), *available at* https://www.govinfo.gov/content/pkg/FR-2022-04-04/pdf/2022-07065.pdf; and Federal Reserve, Principles for Climate-Related Financial Risk Management for Large Financial Institutions, 87 Fed. Reg. 75,267 (Dec. 8, 2022), *available at* https://www.govinfo.gov/content/pkg/FR-2022-12-08/pdf/2022-26648.pdf. The Principles most closely resemble the Federal Reserve's draft principles.

[3] Principles, at 14.

[4] Statement by Vice Chair for Supervision Michael S. Barr on Principles for Climate-Related Financial Risk Management for Large Financial Institutions (Oct. 24, 2023), *available at* https://www.federalreserve.gov/newsevents/pressreleases/barr-statement-20231024b.htm.

[5] Statement by Governor Michelle W. Bowman on Principles for Climate-Related Financial Risk Management for Large Financial Institutions (Oct. 24, 2023), *available at* https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20231024b.htm.

[6] *See* Statement by Governor Christopher J. Waller on Principles for Climate-Related Financial Risk Management for Large Financial Institutions (Oct. 24, 2023), *available at* https://www.federalreserve.gov/newsevents/pressreleases/waller-statement-20231024b.htm ("...I don't believe the risks posed by climate change are sufficiently unique or material to merit special treatment relative to other risks."); Statement by Vice Chairman Travis Hill on the Interagency Guidance on Principles for Climate-Related Financial Risk Management for Large Financial Institutions (Oct. 24, 2023), *available at* https://www.fdic.gov/news/speeches/2023/spoct2423d.html ("The probability that climate-related risks could someday result in bank failures is of course not zero, but I am unpersuaded that it is sufficient to justify elevating climate above a range of other risks banks face."); Statement by Jonathan McKernan, Director, FDIC Board of Directors on Climate Risk Guidance (Oct. 24, 2023), *available at* https://www.fdic.gov/news/speeches/2023/spoct2423g.html ("...this guidance's singular focus on just this one possible emerging risk among many exposes the real intent and effect. This guidance positions the U.S. bank regulators to follow the lead of their European counterparts in pushing banks to facilitate a transition to a lower carbon economy.").

[7] *See* Principles, at 3 and 7.

[8] *Id.* at 12, n. 9.

[9] *Id.* at 14, n. 15.

[10] Statement of CFPB Director Rohit Chopra, Member, FDIC Board of Directors, on the Final Guidance Regarding Climate-related Risks (Oct. 24, 2023), *available at* https://www.consumerfinance.gov/about-us/newsroom/statement-of-cfpb-director-rohit-chopra-member-fdic-board-of-directors-on-the-final-guidance-regarding-climate-related-risks/.

[11] Principles, at 6.

[12] Statement by Chair Jerome H. Powell on Principles for Climate-Related Financial Risk Management for Large Financial Institutions (Oct. 24, 2023), *available at* https://www.federalreserve.gov/newsevents/pressreleases/powell-statement-20231024b.htm.

[13] *Id*.

ENDNOTES (CONTINUED)

14 Acting Comptroller of the Currency Michael J. Hsu Statement in Support of the Finalization of Interagency Principles on Climate-Related Financial Risk Management for Large Banks (Oct. 24, 2023), *available at* https://occ.gov/news-issuances/news-releases/2023/nr-occ-2023-119b.pdf.

15 Principles, at 15.

16 *Id*. at 15-16.

17 *Id*. at 16.

18 Neither the OCC's draft principles nor the FDIC's draft principles addressed compensation policies.

19 Principles, at 9.

20 *Id*.

21 *Id*.

22 *Id*. at 19.

23 *Id*. at 10.

24 *Id*. at 8.

25 *Id*. at 18.

26 *Id*. at 22.

27 *See* Executive Order 14030, Climate-Related Financial Risk (May 20, 2021), *available at* https://www.whitehouse.gov/briefing-room/presidential-actions/2021/05/20/executive-order-on-climate-related-financial-risk.

28 *See* FSOC, *Report on Climate-Related Financial Risk* (Oct. 2021), *available at* https://home.treasury.gov/news/press-releases/jy1655.

29 *See* Press Release, Financial Stability Oversight Council Establishes New Climate-related Financial Risk Advisory Committee (Oct. 3, 2022), *available at* https://home.treasury.gov/news/press-releases/jy0987.

30 FSOC, *Climate-related Financial Risk: 2023 Staff Progress Report* (July 28, 2023), *available at* https://home.treasury.gov/system/files/261/FSOC-2023-Staff-Report-on-Climate.pdf.

31 *See* Spring 2023 Unified Agenda of Regulatory and Deregulatory Actions, SEC, Agency Rule List - Spring 2023, Climate Change Disclosure, *available at* https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202304&RIN=3235-AM87.

32 *See* Federal Reserve, Pilot Climate Scenario Analysis (CSA) Exercise: Participant Instructions (Jan. 2023), *available at* https://www.federalreserve.gov/publications/climate-scenario-analysis-exercise-instructions.htm; *see also* our publication, dated January 24, 2023, *available at* https://www.sullcrom.com/SullivanCromwell/_Assets/PDFs/Memos/sc-publication-fed-issues-instructions-pilot-scenario-exercise.pdf.

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