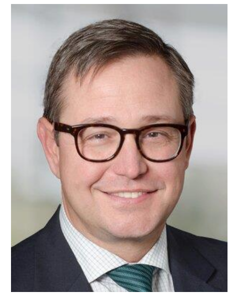
What Banks Can Glean From FSB Climate Risk Report

By **Marc Treviño, Michelle Chen and Alex LePore** (May 19, 2023)



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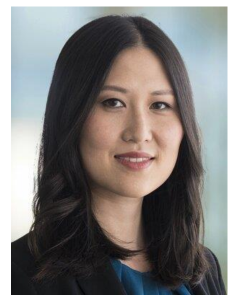

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On April 20, the Financial Stability Board released a report entitled "Climate-related Financial Risk Factors in Compensation Frameworks."[1]

Prepared based on a 2022 survey conducted in FSB member jurisdictions across the banking, insurance and asset management sectors, the report provides insights on how financial institutions incorporate climate-related metrics into their compensation frameworks and identifies related implementation challenges.

Recognizing that this is an area that is in the early stages of development and implementation and is expected to continue to evolve, the report also suggests that financial regulators can facilitate the process by sharing regulatory and industry practices with each other and with the industry.

Although the report "does not aim to present and compare practices across jurisdictions" and "does not provide any specific guidance or expectations,"[2] the report may nonetheless be valuable to financial institutions given the general lack of comparative data on evolving climate-related compensation practices elsewhere.

FSB Report

Background

The report observes that financial institutions are "increasingly using non-financial measures related to ESG in performance measurement to determine variable compensation."[3]

This trend may be driven by regulatory requirements and supervisory guidance.

Based on the 2022 survey noted above, many FSB member jurisdictions have already adopted or plan to adopt regulatory and supervisory frameworks for incorporating climate-related financial risks into compensation frameworks across the banking, insurance and asset management sectors.[4]

The report also notes that international bodies, including the Task Force on Climate-related Financial Disclosures, the International Sustainability Standards Board, the International Association of Insurance Supervisors and the Basel Committee on Banking Supervision, have recognized that linking climate-related objectives with compensation can be a way to incentivize and drive progress for climate-related strategic goals.[5]

Climate-Related Compensation Practices and Trends

The report identifies the following climate-related compensation practices and trends:[6]

- Climate-related metrics tend to be included in the nonfinancial measures, often as part of an environmental, social and governance category that incorporates broader ESG factors, to determine compensation, rather than the financial measures.

- Examples of climate-related metrics include: reduction of carbon footprint (e.g., greenhouse gas emissions reduction, achievement of 100% renewable energy use and climate policy introduction); provision of sustainable finance products (e.g., volume and amount of sustainable business, ESG investments and revenues from ESG financing); accountability-type measures (e.g., ESG and climate-related initiatives, leadership on climate issues and training on corporate sustainability); and external ESG metrics (e.g., ESG ratings and indices).

- There currently appears to be less focus on climate-related risk management metrics in compensation frameworks. This is possibly because climate-related financial risks tend to be included within overall risk measures and linked to a broad range of risk factors and, therefore, may affect financial key performance indicators without being explicitly included.

- Where included in compensation frameworks, climate-related metrics are generally applicable at individual and/or collective levels for executives and senior management (e.g., CEO, chief financial officer, chief risk officer and chief sustainability or climate officer, and certain business heads with climate-related responsibilities).

- Climate-related metrics are incorporated primarily in short-term incentive plans and to a lesser degree in long-term incentive plans. Short-term incentive plans often break down tiered goals on climate-related metrics to single-year milestones.

- At present, the impact of climate-related metrics on total compensation outcomes is relatively modest, due to their small weights or their being used only as an overall adjuster or modifier. However, some financial institutions have reported that "they are increasing the weights for climate-related metrics and moving them to a main component instead of as a modifier."[7]

- The board is generally empowered to exercise its discretion to adjust the climate-related metrics and/or their weight, which could influence compensation outcomes.

- Geographic differences are more significant than sectoral differences with respect to progress in adopting climate-related compensation practices among financial institutions (e.g., inclusion of climate-related metrics in compensation frameworks are generally more common in Europe).

Common Challenges

The report identifies the following common challenges in incorporating climate-related metrics into compensation frameworks:[8]

- Gaps in data availability — including disclosure and transparency — reliability and analysis, i.e., measurement and methodology, make it difficult to incorporate reliable quantitative metrics into compensation frameworks and track performance against climate-related targets.

- It is challenging to develop objectively quantifiable and measurable climate-related metrics that are relevant to and aligned with financial institutions' climate strategies and acceptable to all stakeholders.

- There may be an inherent timing misalignment between a relatively short performance evaluation period of compensation frameworks, e.g., annually, and a relatively long period for achieving climate-related results.

- It is challenging to use climate-related compensation practices to incentivize employees across the organization, including at more junior levels.

- Uncertainty on climate risk, including potential changes in regulatory expectations and government policies related to climate risk, may result in gaps or inconsistencies in the way financial institutions incorporate climate-related metrics into their compensation frameworks.

Implications

As the report acknowledges, climate-related compensation practices remain in an "early, evolutionary stage," but "[i]ncorporation of climate-related metrics into compensation frameworks is expected to evolve further, in line with climate change becoming more prominent as a strategic priority for financial institutions, their regulators and other stakeholders."[9]

In the United States, it is clear that the Biden administration will continue to prioritize its efforts to address climate-related financial risk, and U.S. financial regulators will play an important role as part of those efforts.[10]

Some U.S. financial regulators have already considered issues related to climate-related compensation practices and disclosure in their proposed regulations and supervisory guidance.

For example, the Office of the Comptroller of the Currency, the Federal Reserve and the Federal Deposit Insurance Corp. have each proposed and sought public comment on a set of similar principles outlining a framework for climate-related financial risk management for large banking organizations, i.e., those with over $100 billion in total consolidated assets.[11]

In particular, the Federal Reserve's proposed principles note that a financial institution's board of directors "should consider whether the incorporation of climate-related financial risks into the financial institution's overall business strategy and risk management frameworks may warrant changes to its compensation policies, taking into account that compensation policies should be aligned with the business, risk strategy, objectives, values, and long-term interests of the financial institution."[12]

The federal banking agencies are also expected to finalize a set of interagency guidance on climate-related financial risk management.

In addition, the U.S. Securities and Exchange Commission did not include any specific compensation-related disclosure requirement in its proposed climate disclosure rules because "[it] believe[s] that [its] existing rules requiring a compensation discussion and analysis should already provide a framework for disclosure of any connection between executive remuneration and achieving progress in addressing climate-related risks."

However, the SEC sought public comment on whether it should specifically require a registrant to "disclose any connection between executive remuneration and the achievement of climate-related targets and goals" in addition to the executive compensation disclosure required under its existing rules.[13]

Although the FSB report does not provide any specific guidance, expectations or recommendations for how financial institutions should incorporate climate-related metrics into their compensation frameworks, the report provides insights that may facilitate financial institutions' benchmarking of their own compensation practices against those of their peers.

Financial institutions should continue to monitor developments in climate-related compensation practices, both with respect to regulatory requirements and supervisory guidance as well as market practices, in their relevant jurisdictions and sectors.

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[1] See Fin. Stability Bd., Climate-related Financial Risk Factors in Compensation Frameworks (Apr. 20, 2023), available at https://www.fsb.org/wp-content/uploads/P204023.pdf.

[2] Id. at 3 and 17.

[3] Id. at 3.

[4] Id. at 5-7.

[5] Id. at 3-4.

[6] See Id. at 7-15.

[7] Id. at 1.

[8] See Id. at 15-17.

[9] Id. at 2 & 8.

[10] See, e.g., Executive Order 14030, Climate-Related Financial Risk (May 20, 2021), available athttps://www.whitehouse.gov/briefing-room/presidential-actions/2021/05/20/executive-order-on-climate-related-financial-risk; and White House, A Roadmap to Build a Climate-Resilience Economy (Oct. 14, 2021), available at https://www.whitehouse.gov/wp-content/uploads/2021/10/Climate-Finance-Report.pdf (emphasizing that the United States government is "using all of its tools to properly account for and mitigate climate change-related financial and economic risks").

[11] See 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; 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 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.

[12] 87 Fed. Reg. 75,267, at 75,269. The proposals from the OCC and the FDIC do not address climate-related compensation practices.

[13] SEC, The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21,334, at 21,360 and 21,361 (Apr. 11, 2022), available at https://www.govinfo.gov/content/pkg/FR-2022-04-11/pdf/2022-06342.pdf.