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**Americans for
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Financial Stability Oversight Council

1500 Pennsylvania Avenue

NW, Room 2308, Washington, DC 20220

Re: Docket ID FSOC-2023-0002, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies; and Docket ID FSOC-2023-0001, Analytic Framework for Financial Stability Risk Identification, Assessment and Response

Public Citizen, Sierra Club, Americans for Financial Reform, and The Sunrise Project thank you for the opportunity to comment on the Financial Stability Oversight Council's (FSOC's) proposed nonbank financial company ("NFC") designations guidance ([Guidance](#)), and the related Analytic Framework for Financial Stability Risk Identification, Assessment, and Response ([Framework](#)). As detailed below, we strongly support these proposals. FSOC should strengthen the Framework further by expressly embracing in it (1) the need for a precautionary approach to certain risks—such as climate change—that are irreversible, non-linear, highly significant and uncertain; (2) the possibility that novel risks can be introduced through novel risk transmission channels and require novel risk management measures; and (3) the potential for threats to financial stability stemming from one or more financial companies creating or intensifying financial risks to other firms that have neither created nor willingly assumed those risks and that lack the capacity to manage them.

We urge FSOC to finalize both proposals as quickly as possible and to begin making determinations about nonbanks' systemic importance soon thereafter.

This comment: (1) describes ways the proposed Guidance and Framework are necessary to ensure that FSOC can satisfy its mandate to identify, assess, and respond to potential risks to U.S. financial stability; (2) responds to several specific requests for comment; and (3) identifies strengths of the Framework and areas for improvement.

I. The proposed Guidance and Framework are necessary to ensure that FSOC fulfills its mandate.

A. FSOC was a critically important response to the 2008 financial crisis.

Congress established FSOC under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act” or “Act”).¹ In the wake of the global financial crisis of 2008, a systemic crisis that saw large taxpayer-funded bailouts of a range of institutions following devastating losses in largely unregulated businesses, one of Congress’s principal goals was to prevent future financial crises. To help fulfill that purpose, it created FSOC and empowered it to designate NFCs for enhanced supervision to supplement financial regulatory oversight and cover a fuller range of risks and actors. FSOC helps prevent systemic risks from building up outside of supervisory and monitoring systems.²

The global financial crisis of 2007-2009 was economically catastrophic, causing harms that extended far beyond the financial system and into the broader economy, with grossly disproportionate impacts on low-income, minority, and underserved communities. FSOC must vigorously use all tools at its disposal to avoid future crises.

Due to the global financial crisis, median household wealth in the U.S. dropped 38.8% from 2007 to 2010 (in inflation-adjusted dollars).³ Real wage rates decreased for the bottom 90% of workers, despite productivity growth of 4.8% from 2009 to 2013.⁴ The unemployment rate more than doubled from under 5% to 10%,⁵ and the number of Americans reporting instances of being unable to afford enough food for their families rose by half, from 13.4% before the crisis to 21.1% in 2012.⁶ Poverty rates rose 2.8% for non-elderly adults and 4% for children from 2007 to 2010.⁷ Income loss from the recession was greater for non-whites than whites. Between 2007 and 2013, median household incomes declined by 9.2% for African Americans, 5.7% for Latinos, 5.6% for whites and 9.7% for Asians.⁸ Between 2005 and 2009, African Americans experienced a decline in household wealth of 53% and Latinos lost 66% of household wealth, compared to a

¹ Pub. L. No. 111-203, 124 Stat. 1376 (2010).

² Remarks by Assistant Secretary for Financial Institutions Michael Barr on Regulatory Reform to the Exchequer Club Washington, D.C., (July 15, 2009), available at <https://home.treasury.gov/news/press-releases/tg213>.

³ Federal Reserve Bulletin, “Changes in U.S. Family Finances from 2007 to 2010: Evidence from the Survey of Consumer Finances,” Vol 98, No 2, June 2012. <https://www.federalreserve.gov/pubs/bulletin/2012/pdf/scf12.pdf>

⁴ Heidi Shierholz, “Six Years from Its Beginning, the Great Recession’s Shadow Looms Over the Labor Market,” Economic Policy Institute, 9 Jan 2014. <https://www.epi.org/publication/years-beginning-great-recessions-shadow/>

⁵ John Weinberg, “The Great Recession and Its Aftermath,” Federal Reserve History, Accessed June 13, 2023. <https://www.federalreservehistory.org/essays/great-recession-and-its-aftermath#:~:text=From%20peak%20to%20trough%2C%20US,5%20percent%20to%2010%20percent>

⁶ OECD, “Society at a Glance 2014 Highlights: United States OECD Social Indicators,” March 2014. <https://www.oecd.org/unitedstates/OECD-SocietyAtAGlance2014-Highlights-UnitedStates.pdf>

⁷ Danziger, S., Chavez, K., and Cumberworth, E., “Poverty and the Great Recession,” The Russell Sage Foundation and The Stanford Center on Poverty and Inequality,” October 2012. https://inequality.stanford.edu/sites/default/files/Poverty_fact_sheet.pdf

⁸ Valerie Wilson, “Real Median Household Incomes for all Racial Groups Remain Well Below Their 2007 Levels,” Economic Policy Institute, 16 Sept 2014. <http://www.epi.org/blog/real-median-household-incomes-racial-groups/>

16% decline for whites.⁹ Beginning in 2009, median white household wealth stopped falling but median black household wealth continued to drop, and the median black household lost an additional 13% of its wealth between 2009 and 2011.¹⁰

During the housing boom before the financial crisis, Black homeowners were far more likely to receive costly and predatory subprime loans than white homeowners with similar credit backgrounds,¹¹ and lack of regulatory oversight into mortgage origination, securitization, and overlapping vulnerabilities among firms played a key role in facilitating this predation. As Black families also had a larger proportion of their wealth in home equity before the crisis, the plunge in housing prices during the crisis of 2007-2009 led to disproportionate losses.

B. To avoid future crises, FSOC must effectively address systemic risks posed by banks and non-banks.

The causes of the global financial crisis of 2007-2009 were many, including: predatory lending that targeted Black and Latino consumers for subprime mortgages, opaque securitization that obfuscated underlying risks, excessive risk taking and high leverage by financial institutions, and financial regulatory gaps and failures by regulators who dismissed clear warning signs in the housing market.

Ultimately, the events revealed the potential systemic threats posed by nonbanks. Many nonbank financial firms engaged in high-risk activities without sufficient capital or liquidity and suffered devastating runs. Experts have been clear: “a central lesson of the global financial crisis is that banks are not the only financial firms that can endanger the broader financial system.”¹² The rise of shadow banking and lax risk management by Countrywide, AIG, and others directly led to the crisis.¹³

Nonbank assets have grown significantly in recent years—they make up [nearly half](#) of all global assets—with growing risks to the financial system. The [NY Fed](#) staff, for example, recently highlighted significant risks in the U.S. insurance industry and their significance for stability, “As important financial institutions, insurers’ exposure to climate risk is a key channel through which climate risk can threaten broader financial stability.”

⁹ Pew Research Center, “Wealth Gaps Rise to Record Highs Between Whites, Blacks, Hispanics,” 26 July 2011. <https://www.pewresearch.org/social-trends/2011/07/26/wealth-gaps-rise-to-record-highs-between-whites-blacks-hispanics/>

¹⁰ ACLU, “A Tale of Two Recoveries: Economic Recoveries for Black and White Homeowners,” Accessed June 13, 2023. <https://www.aclu.org/report/tale-two-recoveries-economic-recoveries-black-and-white-homeowners>

¹¹ Sam Thielman, “Black Americans unfairly targeted by banks before housing crisis, says ACLU,” *The Guardian*, 23 June 2015. <https://www.theguardian.com/business/2015/jun/23/black-americans-housing-crisis-sub-prime-loan>

¹² Daniel Schwarz and David Zaring, “Regulation by Threat: Dodd-Frank and the Nonbank Problem,” *U Chi L Rev*, Vol. 84, 2017. <https://chicagounbound.uchicago.edu/uclrev/vol84/iss4/4/>

¹³ Gregg Gelzins, “Strengthening the Regulation and Oversight of Shadow Banks,” Center for American Progress, 18 July 2019. <https://www.americanprogress.org/article/strengtheningregulation-oversight-shadow-banks/>

Despite exponential growth in assets accumulating on non-bank-balance sheets, much of which is subprime,¹⁴our laws and regulations have not kept up, leaving policymakers and regulators in the dark as to the risky practices in some nonbanks that could affect other financial institutions, companies, and their workers. The failure to recognize serious risks in the lead up to the [series of mid-sized bank failures](#) and related market turbulence in 2023 further underlines the need for a comprehensive and precautionary approach to identifying and responding to nonbank risks.

C. Dodd-Frank was intended to address risks originating outside the banking system.

To address potential systemic risks arising outside of the banking sector, Section 113 of the Act gives FSOC the power to designate systemically important NFCs for enhanced supervision and prudential regulation by the Federal Reserve Board if FSOC determines that “material financial distress” of the NFC or the “nature, scope, size, scale, concentration, interconnectedness, or mix” of its activities “could pose a threat” to U.S. financial stability.¹⁵

This is a two-prong test: FSOC may make a determination either based on, for example, the “nature” or “mix” of the NFC’s “activities,” or alternatively based on the potential effects of material financial distress at the NFC. Section 113 sets forth a detailed set of factors that FSOC “shall consider” in making any determination. These include, among others, the extent of the NFC’s leverage; the amount and types of its liabilities; the degree to which it is already regulated by primary financial regulators; and any other “risk-related” factors that FSOC deems appropriate.¹⁶

The proposed Guidance properly implements the statute’s provision that nonbank designations are warranted when material financial distress at a firm “could pose a threat” to U.S. financial stability—not when stability “would” be threatened as the 2019 guidance states. In addition to reflecting the proper reading of the relevant statutory text, the proposal better fulfills its purpose. As FSOC notes, requiring a showing that financial stability “would” be threatened flatly contradicts the mission Congress gave FSOC: to mitigate threats that could impair financial stability “before they are realized,” with the understanding that the “precise severity of the harm” may not be known “until it is too late.”¹⁷

Between 2017 and 2021, the Department of Treasury’s financial stability apparatus was—in the words of Treasury Secretary Yellen—“[decimated](#),” beginning with the elimination of the FSOC team responsible for helping to monitor systemic risk. The disassembling continued through the

¹⁴ Andrew Park, “A Giant in the Shadows: Subprime Corporate Debt,” Americans for Financial Reform Education Fund, Jan 2023.

<https://ourfinancialsecurity.org/wp-content/uploads/2023/01/1.6.23-Subprime-Corporate-Debt-A-Giant-in-the-Shadows.pdf>

¹⁵ Dodd-Frank § 113(a)(1) (emphasis added)

¹⁶ Dodd-Frank § 113(a)(2).

¹⁷ 88 Fed. Reg. at 26,236.

adoption of new guidance interpreting Treasury’s authority to designate NFCs (the 2019 Guidance) in a manner that erects unnecessary and unwise barriers to designation that contradict the relevant text of the Dodd-Frank Act. The current proposal would undo these barriers by making several critical corrections. We support these corrections, all of which address matters central to FSOC’s ability to designate NFCs whose characteristics or activities could threaten U.S. financial stability.

D. NFCs are important sources of climate-related systemic risk

One important way NFCs contribute to systemic risk is through their contributions to climate risk, which occur in two ways. First, they face significant physical and transition risks that could cause their material distress or failure and, in turn, create contagion that threatens financial stability. Second, by financing and insuring emissions, they contribute and exacerbate additional risk to the system.

1. NFCs are facing material distress through growing physical and transition risks.

As acknowledged by the Guidance, NFCs are a source of systemic risk to the extent they face material distress.¹⁸ Increasingly, they appear to be facing material distress related to climate-related physical and transition risks.

Physical risks posed to homeowners are beginning to prompt pullbacks of coverage by insurers in many areas of the U.S., particularly as reinsurance is becoming more difficult to secure. This has potential implications for financial stability, as numerous Federal Reserve Board staff reports indicate. One [noted](#), for example, “This pullback in insurance coverage could be a financial system vulnerability with a variety of second-order effects, many of which are beginning to be visible in the property and casualty insurance markets of some states.” These insurers remain highly interconnected. AIG, for example, was [not significantly different](#) in size and financial interconnectedness when its designation was removed in 2017 than it had been when designated in 2013. And there is little reason to believe it is significantly less interconnected or systemically important at present. Moreover, climate-related risks are likely creating additional, less obvious, interconnections—including, for example, through direct impacts to local economies and related risks that flow to insurers and other financial entities—as well as increased and less predictable asset vulnerabilities.

Second, as policies, technologies and consumer and worker preferences evolve to favor renewable energy sources, [transition risks](#) to NFCs are significant, and losses can also propagate to other entities indirectly through highly connected financial networks. A recent [New York Fed](#) staff report states, for example, that on the asset side of insurer’s balance sheets, the potential for stranded assets can

¹⁸ See 88 Fed. Reg. at 26,235.

... magnify the impact on insurers' current and future profits, ultimately leading to systemic undercapitalization of the insurance sector. The global financial crises have demonstrated the negative externalities that arise from undercapitalized financial institutions including insurance companies, emphasizing the importance of addressing potential climate change risks.” Financial instruments tied to carbon-intensive sectors could face a sudden and dramatic repricing as policies restrict and raise the price of carbon.

2. *NFCs are contributing to systemic risks through their activities.*

The proposed Framework and guidance also rightly reflect that NFCs can pose systemic risk not only as a result of their failure, but also through their activities. One important way this occurs is through NFC investments in, and underwriting of, fossil fuel-related activities. This NFC financing of emissions is significant. Thirty of the largest [asset managers](#), for example, hold approximately \$82 billion in companies involved in coal expansion as of November 2021, and approximately \$468 billion in major oil and gas companies as of March 2022. U.S.-based asset managers account for [nine of the 20](#) largest nonbank contributors. Private equity (PE) firms, although smaller than the largest asset management firms referenced above, are another significant source of financed emissions, with far less transparency. As noted by [Reclaim Finance](#), ten of the world's largest firms—such as Blackstone, KKR, and the Carlyle Group—collectively own more than 300 energy companies, 80% of which are reliant on oil, gas, and coal. Large [insurance companies](#), such as State Farm, have invested hundreds of billions of dollars in fossil fuel interests.

Through such activities, NFCs are, essentially, originating and distributing risks to the financial system in a manner not dissimilar to the origination and distribution of risks by lenders and securitizers of mortgage-backed securities during the 2008 financial crisis. Lenders during the 2008 financial crisis were able to create risky assets but disassociate themselves from the direct impact of those risks by removing subprime mortgages from their balance sheets and shifting them, in an opaque manner, to other entities and to consumers. In the financed emissions context, large NFCs financing and underwriting fossil fuel-related activities are similarly outsourcing risks. They are originating loans to the fossil fuel industry, and risks associated with these loans—including physical risks associated with fossil fuel-related emissions, as well as transition risks associated with the distributed loans—are being broadly disseminated to other entities (and individuals).

Smaller financial institutions, such as smaller insurers and regional and community banks and credit unions are particularly vulnerable to the physical risks that NFCs are creating or exacerbating. Insurers are already fleeing from, failing in, or pulling back on coverage in coastal states such as Louisiana, Florida, Texas and California, and insurance premiums are soaring in those states and others. As consumers lose access to insurance, they may take on uninsured losses and struggle to pay their bills and taxes, and related financial risks will [flow](#) to banks in

the form of unpaid loans and municipalities as unpaid taxes. If many entities in the same area face these risks at the same time, these correlated risks could be significant. It's possible that the failure of medium-sized banks could create contagion that leads to bank runs, as Silicon Valley Bank's failure did. In any event, these subsystemic shocks, facilitated by the financed and insured emissions of larger financial institutions, including NFCs, could be initiating a [slow-motion systemic crisis](#). As detailed more below, consumers disproportionately impacted include BIPOC communities that live in more vulnerable locations due to redlining.

II. Comments on the proposed Guidance, including responses to select “Questions for Comment”

As an increasing percentage of capital moves through NFCs, these institutions are becoming significant sources of climate-related systemic risk, as detailed below. The proposed Guidance removes critical barriers to identifying, assessing, and addressing this risk, including through removing requirements for FSOC to (1) take an “activities-based approach,” (2) perform unnecessary and risk-enhancing cost-benefit analyses, and (3) establish a likelihood that NFCs will face material distress.

A. So-called “activities-based approach” (Question 4)

We support eliminating the 2019 Guidance's statement that FSOC will not pursue entity-specific determinations under Section 113 before first relying on federal and state regulators to address the relevant risks or attempting to use other authorities before designations.¹⁹ The 2019 Guidance labels this an “activities-based approach.” However, that term is confusing because under a proper reading of the statute, “activities” comprise a substantial set of reasons to designate entities, the second prong of the designation standard, and have nothing to do with deferring to federal or state regulators. FSOC should not only reject this standard from the 2019 Guidance, but expressly reject the name that guidance gave it and instead refer to it another way. Going forward, it would be useful for FSOC, other regulators, and nongovernmental organizations to be able to use the terms “activities” and “activities-based” to refer to the set of proper, statutory bases for designations without creating confusion whether they are referring to the statutory standard or the 2019 Guidance's standard.

Regarding the substance of the 2019 standard, the proposal rightly recognizes that FSOC should respond to risks however appropriate under its authorities, not erect needless barriers to designation that have no basis in the text of the Dodd-Frank Act.²⁰ Worse than just artificially de-prioritizing designations, the 2019 guidance virtually precludes their use. Instead, that standard requires deferring to other financial regulatory authorities to address potential risks and establishes an extensive process that could delay a designation for more than six years. The events of 2008 clearly showed this approach to be inadequate. In addition to delaying

¹⁹ 88 Fed. Reg. at 26,235, 26,237.

²⁰ 88 Fed. Reg. at 26,237.

designations until long after it might be too late to prevent financial instability, the 2019 standard purports to defer to regulators who may lack the mission, incentive, authority, or expertise to address systemic risks, effectively erasing a significant component of Dodd-Frank’s systemic risk regulation framework. In the absence of FSOC designations, the entities at issue—NFCs, some of which bore major responsibility for the 2008 crisis—lack any proper oversight for systemic risk, and only one set of them (insurers) is regulated for microprudential purposes.

The 2019 standard’s deference to other regulators is also superfluous. In making NFC determinations, FSOC is required to consider the “degree to which the company is already regulated by [one] or more primary financial regulatory agencies.”²¹ Furthermore, FSOC is made up of Federal financial regulators and interacts regularly with federal and state financial regulators to identify and respond to financial stability risks in the normal course of its work, and its statutory duties include promoting interagency collaboration and making recommendations to existing regulators.²² The proposed guidance properly establishes that FSOC will continue to work with federal and state regulators without being limited in its ability to use its own authority timely and properly to mitigate systemic threats.

To the extent the 2019 guidance is focused on activities, it gives short shrift to another important aspect of the statute’s designation standard—the [characteristics](#) of a firm in terms of its size, funding profile, interconnections, complexity, and opacity. The contribution of NFCs to the 2008 global financial crisis was not attributable to any single activity that propagated risk through the system. Instead, multiple high-risk activities, combined with corporate structure and financing decisions, contributed to the accumulation of systemic risk and ultimately to the crisis. Requiring FSOC in all cases to prioritize an activities-based approach, as called for by the 2019 Guidance, slows potentially necessary NFC designations in a manner that prevents FSOC from effectively addressing risks arising from matters like the funding, leverage, and combination of activities *within* an NFC. It thus prevents FSOC from acting on a broad set of situations that it was intended precisely to address. It prioritizes the avoidance of “competitive concerns” over financial stability, in defiance of the clear requirements of the statute.

Finally, the proposed Guidance does not preclude regulatory agencies from leading on necessary risk-mitigating regulation, as several already are. The SEC is moving ahead with [proposed regulation](#) that would regulate and standardize climate disclosures from public companies, including publicly-traded financial institutions, which levels the information playing field for market actors and provide regulators with a better understanding of how institutions are managing for and responding to emerging climate risks and opportunities. The Federal Reserve is beginning to conduct [climate scenario analyses](#) to evaluate large banks’ climate-risk management practices and preparedness, and it could adopt measures to mitigate not only microprudential risk, but also emerging macroprudential threats as well.

²¹ Dodd-Frank Act § 113(a)(2)(H).

²² See, e.g., *id.* §§ 112(a)(2); 120.

The proposed Guidance will permit FSOC to address entity-based systemic risks when appropriate, consistent with the requirements of Dodd-Frank. It also will permit FSOC to continue to work with primary regulators, without requiring it to wait for broad solutions from such regulators.

B. Cost-benefit analysis (Question 8)

We support elimination of the statement in the 2019 Guidance that FSOC will make a determination under Section 113 only if the expected benefits to financial stability outweigh the expected costs that a determination would impose. Section 113 imposes no requirement to conduct a cost-benefit analysis. Instead, it clearly imposes a duty on FSOC to designate an NFC when it determines that it could pose a risk to financial stability. The statute lists several considerations FSOC must weigh in making this determination. Costs and benefits are not among the listed considerations, and even the catchall consideration for other factors that FSOC “deems appropriate” requires that those factors be “risk-related.”²³ Imposing the requirement of a cost-benefit analysis is contrary to the explicit mandate of Section 113 and greatly reduces FSOC’s ability to take timely action on financial stability risk. As FSOC notes in the proposal, “Congress itself determined” that the benefits of a designation outweigh the costs.²⁴ Although the costs of a financial crisis (and therefore the benefits of preventing it) would be difficult to calculate in advance, they easily run in the trillions of dollars,²⁵ multiple orders of magnitude greater than the costs of designation. Moreover, the benefits of designation might outweigh the costs even for individual firms itself, independent of the value of maintaining systemic stability. It is not uncommon for firms to take on excessive risk and fail as a result, just as they did in the runup to the 2008 financial crisis. For these firms, enhanced prudential regulation and supervision would be a net benefit, not a cost.

C. Likelihood of material financial distress (Question 8)

We also support eliminating the requirement in the 2019 Guidance that, in making any determination under the first prong of Section 113, FSOC must assess not only the potential impact, but also the likelihood of the NFC’s material financial distress. This requirement is inconsistent with the language and clear intent of Section 113, which expressly permits designation if material financial distress at the NFC “*could* pose a threat” to U.S. financial stability.²⁶ As would be expected given the history of the 2008 crisis, the Dodd-Frank Act clearly contemplates the need to bring NFCs within prudential supervision before they are on the verge of collapse, a point when prudential supervision is too late.

Serious financial distress at large firms occurs so rarely, and can result from such complex sets of conditions, that—as history shows—both markets and regulators are unlikely to accurately assess

²³ Id. § 113(a)(2)(K).

²⁴ 88 Fed. Reg. at 26,238.

²⁵ Id.

²⁶ Dodd-Frank Act § 113.

the likelihood of such distress until quite late. The market’s assessment of the probability of AIG’s default for example, was [extremely low](#) even when the global financial crisis was beginning to unfold. For designation to be effective at managing systemic risk, it must be deployed sufficiently early so that prudential supervision can have a chance to operate to manage that risk. This could take several years.

Consistent with the text and purpose of section 113, FSOC must have the ability to subject to prudential supervision NFCs whose material distress or failure *could* threaten U.S. financial stability—including NFCs that might face material distress from climate-related risks. Waiting until a firm is already on the verge of failure to even begin the process of subjecting that firm to supervision and prudential standards fatally undercuts the structure of the designation authority. Tying FSOC’s hands in this respect until failure is probable or even inevitable subverts the language and purpose of the statute, and is willfully blind to the lessons of 2008. The requirement in the 2019 Guidance that FSOC must take the likelihood of an NFC’s material financial distress into account before making a designation contradicts the statute, and eliminating it will reestablish the proper, lawful manner in which FSOC should consider potential threats to financial stability.

III. Proposed Analytic Framework for Financial Stability Risk Identification, Assessment, and Response

A. Strengths of the Analytic Framework

- 1. The Analytical Framework is useful for identifying, assessing and addressing climate-related risks to financial stability.*

We welcome the Framework’s attention to climate-related financial risk as a “development affecting the resiliency of the financial system” and a potential risk to financial stability. This is consistent with FSOC’s October 2021 [determination](#) that climate risk is an emerging threat to financial stability, and Treasury Secretary Yellen’s [acknowledgement](#) that we need to “mitigate the risks that climate change poses to U.S. financial stability.” The importance and challenges of this task were underscored in October 2022, when, after a decade of existence, the FSOC’s first external advisory committee—the [Climate-related Financial Risk Advisory Committee](#)—was constituted to gather information on, conduct analysis of, and make recommendations to identify, assess, and mitigate climate-related risks to the financial system.

Financial risk due to climate change is a global risk. This has been recognized by the G20, which tasked the Financial Stability Board (“FSB”) to develop a [roadmap](#) to address climate-related risks given that such risks could have a destabilizing effect on the financial system, including through “a rise in risk premia and falling asset process.” The [Bank for International Settlements](#) similarly details ways climate change threatens financial and price stability. And the [European Central Bank](#) describes the need for a macroprudential approach to climate risk, noting that cross holdings and common exposures across the financial system will likely amplify the

materialization of these risks, and that a macroprudential approach is best suited to addressing risks associated with excessive lending to high carbon projects. Finally, a growing body of research underscores the gravity of [physical](#) and transition risks for financial stability.

The Framework provides the forward-looking approach necessary to effectively mitigate highly uncertain and significant risks to financial stability, including those posed by climate change.

2. The Framework identifies key climate-related financial system vulnerabilities and transmission channels.

The Analytic Framework identifies key financial system vulnerabilities. As the brief discussion below indicates, climate risk intersects with all itemized vulnerabilities, including leverage, liquidity and maturity mismatch, interconnectedness, complexity and opacity, inadequate risk management, concentration, and destabilizing activities:

- **Leverage:** The repricing of assets as a consequence of physical shocks or new policies could lead to dramatic losses at leveraged financial intermediaries. Sea level rise and more frequent and severe hurricanes, [for example](#), are leading to decreased coastal real estate prices and reduced access to insurance, with threats of losses to financial intermediaries with exposure to real estate loans and mortgage backed securities. More frequent and severe storms are the [primary cause](#) of Florida’s collapsing property insurance market, as [16 insurance companies](#) have either become insolvent, dropped policyholders, or left the state (as of July 2022).
- **[Liquidity and maturity mismatch](#):**²⁷ Climate risk can also exacerbate liquidity and maturity mismatch, as evidenced by ways climate change exposes and exacerbates the duration mismatch between mortgages and insurance policies and resultant harms. Thirty year mortgages are long-term assets that must be paired with property and casualty insurance policies renewed yearly. As insurers exit climate vulnerable areas, individuals with long-term mortgages will have a difficult time repaying their loans, and the value of mortgage assets in these areas will also be impacted.
- **Interconnections:** Climate risk is a particularly significant source of [contagion](#) because a deeply interconnected financial system is layered on top of interconnected economic sectors, which is then layered atop interconnected earth systems.²⁸ There are any number of examples highlighting how acute and long-term environmental disturbances (discrete natural disasters or heightened risk of drought, sea level rise, wildfires) lead to the withdrawal of critical services (e.g., insurers already fleeing from coastal states with heightened hurricane, flooding, and wildfire risk), insolvency (e.g., Hurricane Andrew led to the [insolvency](#) of 7 domestic insurance companies), and negative [asset valuation](#).

²⁷ Graham Steele, “Confronting the ‘Climate Lehman Moment’: The Case for Macroprudential Climate Regulation” 30 Cornell J.L. & Pub. Pol’y 109 (2020). https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3542840

²⁸ Id.

[Research in capital market assets](#) found that a 1°C increase in temperature resulted in a decline in equity valuation of approximately 5%, with losses becoming greater over time. Through direct and indirect transmission channels, climate change can trigger spillover risks and feedback loops, and create contagion across portfolios and asset classes simultaneously.

- Operational Risks: Climate change also creates significant [operational risks](#) that can occur through behavioral change, economic shocks and physical impacts. Late action on climate risk, for example, could create a demand-side economic shock that could drive significant operational risk losses.
- Complexity/opacity: Climate risk can be heightened, as well, by a lack of transparency.²⁹ Information gaps, for example, related to exposures of financial institutions to both transition and physical climate risks could lead to panics and runs. Additionally, severe data limitations—including those related to the interconnectedness of energy, water, agriculture and economic and financial systems—can inhibit accurate modeling of climate risk.³⁰ A [Federal Reserve Board meta-analysis](#) of financial stability modeling methodologies for climate-related risks concludes that existing approaches are “characterized by a large degree of uncertainty.” Results are unreliable and insufficient to assess climate-related financial stability risks for the U.S.. High degrees of uncertainty regarding the climate system, how and when countries and corporates will respond, and assumptions about technological innovation further complicates modeling.
- Inadequate risk management: Inadequate management of climate risk, including, for example, inadequate [capital requirements](#) for NFCs facing stranded asset risks, can pose risks to those entities and to financial stability.
- Concentration: Climate risks can be concentrated sectorally and geographically. Climate risk is highly concentrated sectorally, for example, in six of the largest U.S. financial institutions financing the fossil fuel industry. Six U.S. banks are responsible for approximately [35% of financing](#) for the fossil fuel industry since the signing of the Paris Agreement. It can also be concentrated geographically, as regional and community banks in climate vulnerable areas face risks to physical infrastructure and resources tied to their loans, but they can’t easily move to avoid such risks.
- Destabilizing activities: Financing for activities that aren’t aligned to 1.5C warming pathways—including financing of fossil fuel expansion and deforestation—can

²⁹ Id.

³⁰ For example, [economic projections by Swiss Re Institute](#) lack data on tipping points. Research on ecosystem services by Swiss Re, climate analytics by [BlackRock and Rhodium](#), and climate impact projections from the [Congressional Budget Office](#) all account for only first-order impacts. They calculate valuation of loss of assets and loss to productivity from climate impacts at an idiosyncratic level, but fail to calculate the repercussions of those impacts - e.g., how loss of agricultural productivity in key regions may lead to higher prices.

significantly heighten the risk of market destabilization. We welcome the document’s acknowledgment that destabilizing activities can include intentional and legal activities, as well as those involving moral hazard. The provision of finance, insurance, and other financial services to companies that are expanding fossil fuel assets is legal, yet increases financial system instability. And one of the key problems with climate-related financial stability risks is that these risks are easily externalized by financial institutions, leading to significant moral hazard. Failing to hold financial institutions accountable for their individual contributions to destabilizing activities through facilitated and financed emissions creates externalities that will be borne by the public, by [governments](#), and by other financial institutions.

Additionally, climate risk could materialize through any of the identified transmission channels: high exposure to risky sectors could translate to firm distress; any number of physical or transition risks could lead to rapid asset liquidation; insurance companies are already rolling back critical services; and the high degree of interconnectedness in the system of assets and activities that drive systemic climate risk make the system vulnerable to contagion.

- 3. The proposed definition of “financial stability” supports a forward-looking approach to climate risk.*

We support the proposed definition of “financial stability.” The definition correctly observes that financial stability requires a financial system that can support economic activities such as “allocating resources” and “managing risks.” As climate change, for example, reduces water supplies in some areas, it creates insecurity for consumers, businesses, and institutions that depend on that water. When these consumers, businesses, and institutions are unable to secure the resources they need, their ability to satisfy their financial obligations to lenders can be compromised. These individual shocks can accumulate to create a larger systemic concern. As physical climate risk derives from impacts to our environmental system that rebound onto the financial system, it is much more difficult to manage once it materializes. Many such impacts to the environmental system are irreversible, and the best risk management measures are those that prevent risks from originating. Relatedly, the definition correctly recognizes that risks to financial stability also include those arising from “long-term vulnerabilities or from sources that are new or evolving.” Climate change-related financial risk is a “new risk or evolving risk” likely requiring novel risk-management measures. We note, however, that FSOC should consider a risk as arising “from within the financial system” if financial institutions contribute substantially to the risk, even if it is a risk that nominally looks “external”—like climate-related physical risks.

- 4. The Framework provides useful attention to the need for FSOC to monitor risks to low-income, minority, and underserved communities.*

We strongly support FSOC’s attention to its mandate to address risks to “low-income, minority, or underserved communities.” Climate change heightens fair lending, fair housing, and other

equity concerns, as has been recognized by federal banking regulators and the Financial Stability Oversight Council.³¹ In recent years, climate impacts—especially in underserved communities—are leading to ever-increasing chronic damages,³² disruption to local economies based on agriculture, tourism, and energy,³³ and sometimes ultimately emigration³⁴ and loss of tax base,³⁵ effectively bankrupting towns across the country³⁶ and destabilizing local financial institutions.³⁷ Underserved communities tend to be both the most exposed to these damages and least able to access the federal aid resources to recover financially.³⁸ At the same time, climate gentrification is becoming a twin problem to climate vulnerability: when low-income populations *do* live in areas that are more resistant to climate change, they are increasingly being priced out of these areas as they become more sought-after by higher income residents.³⁹

Inequitable access to post-disaster recovery aid is a persistent driver of inequality that compounds disaster losses for underserved communities. In 2020, the National Advisory Council to FEMA troublingly found that “Many FEMA programs do not consider the principle of equity in financial assistance relief... Through the entire disaster cycle, communities that have been underserved stay underserved, and thereby suffer needlessly and unjustly.” In fact, research has shown that

holding disaster costs constant, the more [FEMA] money a county receives, the more whites’ wealth tends to grow, and the more blacks’ wealth tends to decline, all else equal. In other words, how federal assistance is currently administered seems to be exacerbating rather than ameliorating wealth inequalities that unfold after costly natural hazards.⁴⁰

When managing climate-related financial risk, it is critical that financial institutions do not retreat from climate vulnerable communities, but instead find ways to promote climate resilience

³¹ <https://home.treasury.gov/system/files/261/FSOC-Climate-Report.pdf>

³² NOAA, “Billion-Dollar Weather and Climate Disasters,” 2022. <https://www.ncdc.noaa.gov/billions/>

³³ U.S. Global Change Research Program, “Fourth National Climate Assessment -Volume II: Impacts, Risks, and Adaptation in the United States,” 2018. <https://nca2018.globalchange.gov>

³⁴ The NYTimes and ProPublica, “The Great Climate Migration,” 2020. <https://www.nytimes.com/interactive/2020/07/23/magazine/climate-migration.html>

³⁵ Organisation for Economic Co-operation and Development (OECD), “Climate Change and Long Term Fiscal Sustainability,” 2021.

<https://www.oecd.org/gov/budgeting/scoping-paper-on-fiscal-sustainability-and-climate-change.pdf>

³⁶ The NYTimes, “Climate Change is Bankrupting America’s Small Towns,” September 2021.

<https://www.nytimes.com/2021/09/02/climate/climate-towns-bankruptcy.html>

³⁷ The Wall Street Journal, “Banks Take a Hit from Hurricanes Katrina, Rita,” 2005.

<https://www.wsj.com/articles/SB112993899645076384>

³⁸ Urban Institute, “Improving Disaster Recovery of Low-Income Families.”

<https://www.urban.org/debates/improving-disaster-recovery-low-income-families>

³⁹ Elizabeth Santiago, “Weathering the Storm: Climate Gentrification in Miami’s Little Haiti,” 10 Feb. 2020.

<https://sph.umich.edu/pursuit/2020posts/weathering-the-storm-climate-gentrification-in-miami.html>

⁴⁰ FEMA National Advisory Council, “National Advisory Council Report to the FEMA Administrator,” November 2020.

https://www.fema.gov/sites/default/files/documents/fema_nac-report_11-2020.pdf;

Howell and Elliott, “As Disaster Costs Rise, So Does Inequality,” *Socius*, 4 Dec 2018.

<https://journals.sagepub.com/doi/full/10.1177/2378023118816795>

for their customers and communities. “Bluelining” is a developing practice where financial institutions avoid offering insurance, credit, and banking services, or raise costs to unaffordable levels in areas they identify as having higher environmental risk, often with little to no warning.⁴¹ Without a holistic risk-based analysis that includes fair lending and equity concerns, financial institutions will recreate the same patterns of racial and economic exclusion as previous redlining activities.

Unfortunately, bluelining is becoming more prominent as the climate crisis accelerates and climate-exacerbated insurance disruptions make parts of America uninsurable.⁴² Recent research also reveals signs of credit rationing in areas where climate change is exacerbating flood risk, and notably, mortgage availability is shifting towards wealthier borrowers with higher FICO scores, lowering access for low income consumers.⁴³ FSOC must monitor financial firms’ use of bluelining, which itself constitutes a first order and immediate threat to access to credit and liquidity for low-income, minority, or underserved communities, which the Guidance rightly recognizes as an aspect of financial stability within its statutory ambit.

B. Ways the Analytic Framework can be strengthened

Climate-related financial risks echo the financial risks triggering the pathways of past financial crises. However, several unique features of climate risk, including its non-linear nature, its relative irreversibility, and its complexity, point to ways the Analytic Framework should be strengthened. As was observed by Assistant Secretary of the Treasury Graham Steele, climate risk is “the very type of new challenge that Dodd-Frank was intended to address.”⁴⁴

Climate impacts [escalate significantly](#) as the temperature warms, i.e., going from 1 degree of warming to 2 degrees is much worse than 0 to 1. Non-linearity is evident, as well, in the finding that after a certain quantity of carbon has been added to the atmosphere, each additional quantity added will have a greater impact than that same quantity removed. Unlike past systemic shocks,

⁴¹ Abraham Lustgarten, “[How the Climate Crisis Will Shape Migration in America](#),” The NYTimes, 15 Sept. 2021; Renee Cho, “[With Climate Impacts Growing, Insurance Companies Face Big Challenges](#),” <https://news.climate.columbia.edu/2022/11/03/with-climate-impacts-growing-insurance-companies-face-big-challenges/>; Michael D. Berman, “[Flood Risk and Structural Adaptation of Markets: An Outline for Action](#),” Community Development Innovation Review, 17 Oct. 2019.

<https://www.frbsf.org/community-development/publications/community-development-investment-review/2019/october/flood-risk-and-structural-adaptation-of-markets-an-outline-for-action/>;

Tim McDonnell, “[How new flood risk maps could undermine marginalized neighborhoods](#),” Quartz, 5 July 2020. <https://qz.com/1876202/new-flood-risk-maps-could-undermine-marginalized-neighborhoods/>; Teke Wiggin, “[‘Blue-lining’ could be the new redlining, Fed branch warns](#),” Inman, 18 Oct. 2019.

<https://www.inman.com/2019/10/18/blue-lining-could-be-the-new-redlining-fed-branch-warns/>;

⁴² <https://www.nytimes.com/2023/05/31/climate/climate-change-insurance-wildfires-california.html>

⁴³ Sastry, Parinitha. *Who Bears Flood Risk? Evidence from Mortgage Markets in Florida*, MIT Sloan School of Management, 2021. Available at: https://psastry89.github.io/website/psastry_JMP.pdf; Kristian Blickle et al., “[The Adverse Effect of “Mandatory” Flood Insurance on Access to Credit](#),” Liberty Street Economics, 23 May 2022. <https://libertystreeteconomics.newyorkfed.org/2022/05/the-adverse-effect-of-mandatory-flood-insurance-on-access-to-credit/>

⁴⁴ https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3542840, p . 141

many of the critical thresholds or tipping points will lead to significant and irreversible change in the state of the system, which cannot be addressed by technological or policy changes. The [radical uncertainty](#) characterizing climate-related financial risks creates significant complexities that are difficult to model and manage. For the following reasons, the [major methodologies](#) used to study the impact of climate change on financial system vulnerabilities all are incomplete.

1. *The Framework should acknowledge that a precautionary approach to highly uncertain, significant, and irreversible risks is central to FSOC's mission.*

Vice Chair for Supervision Michael Barr's [recent post-mortem](#) of Silicon Valley Bank's failure acknowledges that regulators and bank managers must be more willing to bring a "precautionary perspective" to risk, and err on the side of caution when it comes to potential threats that could topple the entire financial system. As research indicates, climate change is just such a threat.

A [report](#) by actuaries critiquing existing approaches to climate models observes, for example, that current techniques to climate modeling

exclude many of the most severe impacts we can expect from climate change, such as tipping points and second order impacts – they simply do not exist in the models. The consequence of this is that the results emerging from the models are far too benign, even implausible in some cases. It's as if we are modelling the scenario of the Titanic hitting an iceberg but excluding from the impacts the possibility that the ship could sink, with two thirds of the souls on board perishing.

And as Steele [observes](#),

unlike other financial crises and recessions that last for months or years, many of the risks arising from climate change are irreversible and will last for a much longer period. As such, short-term interventions that have sufficed to stabilize financial markets during previous panics will not stem the potential damage caused by climate change.

FSOC's reasoning regarding the reasons why it need not, and should not, determine that an NFC is likely to become distressed provides a close parallel to the need for a [precautionary approach](#) to many systemic risks, and in particular climate-related risk.⁴⁵ Regarding climate-related risk,

⁴⁵ Chenet et. al, "Developing a precautionary approach to financial policy – from climate to biodiversity" Inspire Policy Brief, April 2022.

<https://inspiregreenfinance.org/wp-content/uploads/2022/04/Chenet-et-al-April-2022-Developing-a-precautionary-a-pproach-to-financial-policy-from-climate-to-biodiversity.pdf>

The authors observe that the 'radical uncertainty' characterizing the long time horizons and the endogenous and non-linear dynamics involved with environmental change make quantitative calculations of financial risk challenging, if not impossible. The precautionary approach draws on the 'precautionary principle' and modern macroprudential policy traditions. A precautionary financial policy mindset acknowledges the importance of measurement practices and price discovery but justifies bolder policy action to shift the allocation of capital to

FSOC and other regulators must act on the basis of imperfect information, well before the risks materialize. The tools they could apply in response must be used well in advance to be effective, and some risks could materialize rapidly, even in a matter of days. For example, if regulators wait to mitigate transition risk until they feel there are strong signs that policymakers or the clean-energy transition are reaching an inflection point that makes mitigatory action necessary, they will likely be too late. Markets will have already moved, and financial collapse will be imminent—or will have already happened. If, by contrast, regulators signal that they will not mitigate climate-related financial risk until modeling demonstrates that the risk reaches a certain level of likelihood or severity, then that very modeling may trigger financial instability well before regulators act—or their movements toward action might spark instability.

- 2. The Framework should acknowledge not only “new and evolving risks” but also the possibility of new risk transmission channels associated with these risks and the need for new risk management measures.*

As detailed by experts, including those at the [Basel Committee on Banking Supervision](#), climate change-related financial risk includes novel risk transmission channels and characteristics. Recent research by Federal Reserve Board staff, for example, describes the “[flow of risk](#)” associated with physical climate risk. Climate risk can be initiated through direct physical impacts to insured consumer-owned assets and spread to banks and other entities in ways more traditional risks aren’t as commonly and/or significantly initiated and spread. Climate risks can also be initiated indirectly through impacts to the real economy, through, for example, physical impacts to water supplies, soil conditions, etc., in ways more traditional risks aren’t as often, or as significantly, indirectly initiated. These indirect risk transmission channels can also threaten financial stability. These realities point to the need for risk management measures that more directly address risks and impacts to consumers and to the real economy.

- 3. The Framework should acknowledge that some new or evolving risks, such as those related to climate change, are often being assumed by entities that have not created them or willingly acted to assume them, and that lack the capacity to manage them.*

Important novel risks, particularly those introduced by climate change, are unjustly forcing financial risks onto consumers and a range of entities—including not only financial entities but also municipalities—that aren’t acting to create them or willingly assume them and that lack the capacity to respond to them. Many of these “forced risks” are created by the largest financial entities that secure significant financial gains by not internalizing these risks. As [recognized](#) by Federal Reserve Board staff, these large bank contributions to climate risk raise “double materiality” concerns. Municipalities in hotspot areas are not only increasingly assuming climate risks, but also becoming more important and threatened financial actors in the context of climate change. They are facing increasing threats to the services they provide to private sector entities

shorter time frames better aligned with the uncertain and potentially catastrophic nature of environment-related threats, including the risks to, and posed by, financial institutions.

and consumers, including, for example, water services. They are also facing threats as investors and managers of taxpayer dollars when physical assets, such as real estate, are threatened by climate change. Finally, their abilities to make their municipal bond payments will increasingly be challenged as costs associated with such climate impacts escalate. The framework should acknowledge the forced risks of climate change and the elevated profile and needs of entities, such as municipalities, in this context.

Conclusion

Thank you for the opportunity to comment on these critically important proposals which, while not specific to climate risk, provide a critical foundation for responding to this risk. We encourage you to modify the documents as described above, and finalize them as quickly as possible.

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