Ann E. Misback
Secretary, Board of Governors of the Federal Reserve System
Constitution Ave NW & 20th St NW
Washington, DC 20551

February 6, 2023

Re: Statement of Principles for Climate-Related Financial Risk Management for Large Financial Institutions, Docket No. OP-1793

Dear Ms. Misback,

On behalf of Public Citizen, a national public interest advocacy group, and more than 500,000 members and supporters, we welcome the opportunity to comment on the Statement of Principles for Climate-Related Financial Risk Management for Large Financial Institutions published by the Board of Governors of the Federal Reserve System (FRB).[1] We support this important step toward advancing financial institutions' efforts to assess and address climate-related risk, and we urge the FRB to strengthen and finalize the draft as soon as possible.

Climate change poses significant risks to the safety and soundness of financial institutions, the financial system, and communities. Even since the FDIC issued its own draft climate risk management principles in early 2022, the level of physical and transition risk that banks face has only increased. In September 2022, Hurricane Ian became perhaps the costliest storm to ever strike Florida. The exposure of banks to this storm was exacerbated by the wave of insurance cancellations that preceded landfall, a source of risk recently acknowledged by the Financial Stability Oversight Council. Meanwhile, the passage of the Inflation Reduction Act in August 2022, viewed alongside a subsequent package of California policies designed to phase out internal combustion engines and increase the adoption of renewable energy, represent

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[1] Board of Governors of the Federal Reserve System, Principles for Climate Related Financial Risk Management for Large Financial Institutions, (Principles) (December 8, 2022).

perhaps the most significant regulatory policies and investments in the energy transition that any jurisdiction has made to date. These policies show how quickly the policy landscape can shift, and they are projected to catalyze rapid growth in the adoption of renewable energy. These investments are likely to trigger economic and technological changes that further exacerbate transition risk.

Such developments make strengthening and finalizing the Statement imperative. The Statement appropriately expects large financial institutions to take a whole-of-business approach to mitigating climate-related financial risks, to consider longer time horizons for assessing and addressing climate-related financial risk, to recognize that climate change poses unique financial risks, and to develop climate-related data and scenario analysis modeling. It provides welcome attention to important measures not included in the OCC and FDIC proposals: the need for compensation policies to be aligned to climate-related financial risks and the need for financial institutions to assess the climate-related financial risks associated with individual customer relationships and their ability to manage these risks. The FRB also appropriately acknowledges climate-related financial risks to the U.S. financial system and threats to financial stability,[2] although the FRB should recognize, as the FDIC proposal does, that these threats are significant and near-term.[3] The Statement also importantly directs financial institutions to monitor alignment of their internal strategies with their public climate commitments and to consider the fair lending implications of their risk-management measures and their adverse effects on low-income and other disadvantaged households and communities.

The Statement could be further strengthened in ways that we recommended to the FDIC in response to its proposal (Public Citizen's comments to the FDIC are included in Appendix I to these comments).[4] This includes indicating that climate change threatens not only large US financial institutions but also smaller financial institutions—including, for example, state member banks regulated by the FRB—with implications for access to finance by low- and moderate-income (LMI) and other vulnerable communities. The Statement should also recognize that large financial institutions fuel climate-related financial risks through their financing of greenhouse gas (GHG) emitting activities. This recognition will lay the groundwork for the FRB to work with other federal banking regulators to protect the safety and soundness of all entities and the banking system.

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[2] *Id.* at 75267.
[3] Federal Deposit Insurance Corporation, Principles for Climate Related Financial Risk Management for Large Financial Institutions at 19509.
[4] Public Citizen, Public Citizen Comment on FDIC Principles for Climate Related Financial Risk Management (June 2022).

The FRB should treat this Statement as a first step in a broader regulatory program of protecting financial institutions and the financial system from climate-related financial risks. It should be followed by interagency guidance from all federal banking regulators indicating how banks can implement the expectations they contain. Key areas of focus for both this Statement and follow-up work should include (1) explaining in greater detail how financial institutions should account for the unique aspects of climate-related financial risks and integrate those risks into broader risk management structures; (2) acknowledging limitations of scenario analysis while supporting such analysis for limited objectives; (3) detailing measures needed to address risks to the safety and soundness of smaller financial institutions; (4) providing clarity around what it means for large financial institutions to align their climate commitments to their internal strategies and additional detail on the risk management benefits of credible net zero transition plans; and (5) bringing U.S. climate-related financial risk supervision and regulation practices in line with those at peer central banks. Regulators should also explore ways to incorporate climate-related risks into risk-weighted capital requirements and consider additional measures to address the financial stability implications highlighted in the Statement, such as a climate-related financial risk capital surcharge for the largest financial institutions and concentration and portfolio limits for the riskiest assets.

I. Large financial institutions need more detailed direction on how to address the unique characteristics of climate-related risks and integrate them into existing risk management processes.

The Statement reinforces that weaknesses in how financial institutions identify, measure, monitor and control potential climate-related financial risk can threaten financial institution safety and soundness.[5] To assure the safety and soundness of financial institutions under its jurisdiction, Congress charged the FRB with prescribing standards relating to internal controls, loan documentation, credit underwriting, and other operational and managerial standards, as well as for asset quality. 12 U.S.C. § 1831p-1. Such standards may be prescribed by either regulation or guideline. To appropriately set financial institution expectations, we encourage the FRB to clarify that it is issuing the statement as a guideline under 12 U.S.C. § 1831p-1.

Overall, the Statement provides an important foundation for appropriately integrating climate-related financial risk into a large financial institution's broader risk management structures. The Statement makes clear that financial institutions must address climate-related financial risks management at every level of their business, from the board on down. This approach reflects international best practices, as well as the magnitude of the threat that

[5] Principles at 75267.

climate-related financial risks pose. The Statement also appropriately directs financial institutions not to silo climate-related financial risks, but to make them a part of broader internal controls, including the financial institution's credit risk appetite and lending limits. This approach helps make sure that the breadth of potential climate-related financial risks impacts are incorporated into a financial institution's operations, instead of being siloed in a separate climate-related financial risk function with limited influence on risk taking.

The Statement also starts to recognize the ways that climate-related financial risk differs from other forms of risk that financial institutions ordinarily seek to manage. As other regulators have discussed, the effects of climate-related financial risk will manifest in uncertain ways over a long time horizon.[6] The Statement reflects this by encouraging financial institutions to assess climate-related financial risks over a time horizon that may extend beyond a financial institution's typical strategic planning horizon, and by recommending scenario analysis and other tools for measuring such uncertain exposures.[7] Climate-related financial risks are also highly correlated in ways that may make traditional hedging and insurance approaches to risk management ineffective.[8] The Statement recognizes this by recommending that management assess potential changes in correlations across exposures or asset classes, and set credit risk appetite and lending limits in ways that reflect those potential correlations.[9]

The Statement also offers attention to measures not addressed by the OCC and FDIC, including alignment of compensation policies to climate-related financial risks[10], and efforts by financial institutions to take a risk-based approach to the climate-related financial risks associated with individual customer relationships.[11] Compensation policies to date largely incentivize behaviors that promote fossil fuel-related activities, increasing risks for individual banks and the financial system. New compensation policies with incentives aligned to the need to reduce climate-related financial risks are urgently needed. A risk-based approach to the climate-related financial risks of individual customers should prompt banks to engage more robustly with customers to identify, measure, evaluate, and address these risks, and to modify customer relationships when bank capacity to deal with these risks is challenged.

From this foundation, the Principles can be strengthened or followed up on by providing more detailed expectations for how financial institutions address the risks of climate change. These

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[6] Bank of England, Prudential Regulation Authority, Supervisory Statement SS3/19, Enhancing banks' and insurers' approaches to managing the financial risks from climate change, (April 2019).
[7] Principles at 75269.
[8] New York Department of Financial Services, Guidance for New York Domestic Insurers on Managing the Financial Risks from Climate Change at 15.
[9] Principles at 75270.
[10] Principles at 75269.
[11] Principles at 75269.

additional expectations fall into two categories: additional guidance for how financial institutions should account for the unique aspects of climate-related financial risks, and additional detail on how to integrate those risks into broader risk management structures.

The paper *Looking Over the Horizon: The Case for Prioritizing Climate-related Risk Supervision of Banks*[12], provides detailed recommendations on how to incorporate climate-related financial risks into the FRB's existing risk management frameworks (*Looking Over the Horizon: The Case for Prioritizing Climate-related Risk Supervision of Banks* is included in Appendix I to these comments). Specifically, additional guidance should encourage banks to adopt a precautionary approach to managing the uncertainty and complexity of climate-related financial risks and further explain the importance of mitigating risks that will manifest over a long time horizon. It should also provide specifics on how the bank should incorporate climate-related financial risks into its governance, strategic planning, and risk management framework, including specific risk stripes, such as credit risk, liquidity risk, and operational risk.

II. Financial institutions should recognize the significant limitations of existing approaches to scenario analysis, and they should consider alternatives that help align them to their net-zero commitments.

The Statement rightly calls on financial institutions to use scenario analysis to better understand ways climate change could impact them; these institutions must attempt to orient to and address these risks as quickly as possible. Nevertheless, the Statement does not recognize the significant limitations associated with scenario analysis as conducted to date or what these limitations imply for banks using it to understand and manage climate-related financial risk. The Financial Stability Board (FSB) and Network for Greening of the Financial System (NGFS) recently determined that scenario analysis exercises conducted to date likely significantly understate risks.[13] Many of the limitations they identified—as well as others identified by Reclaim Finance[14] and leading economists[15]—are not referenced in the Statement but are present in the FRB's current pilot scenario exercise.

[12] Yevgeny Shrago and David Arkush, Looking Over the Horizon: The Case for Prioritizing Climate-related Risk Supervision of Banks, (April 2022).
[13] Financial Stability Board and Network for Greening of the Financial System, Climate Scenario Analysis by Jurisdictions: Initial findings and lessons, (November 2022).
[14] Reclaim Finance, NGFS Climate Scenarios: pushing financial players into taking a risky gamble, (July 2021).
[15] Nicholas Stern, Charlotte Taylor, and Joseph Stigliz, The economics of immense risk, urgent action and radical change: towards new approaches to the economics of climate change, (February 2022).

Among the many limitations includes the failure of scenario analyses to reflect that financial institutions likely face much greater difficulties managing climate-related tail risks as compared to more traditional financial tail risks. Scenario analyses that assume comparable difficulties managing risks will underestimate climate risks. Another is the assumption that carbon dioxide removal technologies will effectively mitigate transition risks within needed timeframes—an assertion that flatly contradicts technological realities. A recent study by the Institute for Energy Economics and Financial Analysis (IEEFA),[16] for example, reviewed the capacity and performance of 13 flagship carbon capture projects and found that ten of the 13 failed or underperformed against their designed capacities, and most by large margins. European science academies have warned that expectations for these technologies are 'seriously over-optimistic.'[17]

Finally, economists, including Nicholas Stern, Charlotte Taylor and Joseph Stiglitz have described the integrated assessment models (IAMs) underpinning the NGFS scenarios as "fundamentally flawed" because they both assume away catastrophic risks and focus on trade-offs between environmental benefits at some time in the future versus sacrifices we make today.[18]

The Statement should acknowledge the limitations of scenario analysis as currently conducted and, as an initial remedy, require that banks incorporate a precautionary approach into their analyses. Doing so would be consistent with the Basel Committee on Banking Supervision's recent suggestion that banks "add a margin of conservatism" when estimating possible exposures, given poor data quality, scarce climate-related data, and other sources of additional uncertainties.[19] The Statement could also encourage financial institutions to consider how their risks would change under various pathways to net-zero emissions, supporting financial institutions' efforts to develop credible net-zero plans.

III. Smaller financial institutions need US regulator attention to their safety and soundness.

The FRB is mandated to ensure the safety and soundness of not only large financial institutions, but also numerous regional and community banking organizations that are critically important for LMI communities in the US, as well as the stability of the entire financial system. Indeed, these banks constitute the largest number of banking organizations supervised by the FRB.[20]

[16] Institute for Energy Economics and Financial Analysis The Carbon Capture Crux, (September 2022).
[17] European Academies Science Advisory Council, Negative emission technologies: What role in meeting Paris Agreement targets? (February 2018).
[18] Stern et al, *supra* at 15.
[19] Basel Committee on Banking Supervision, Frequently Asked Questions on Climate-related Financial Risks, (December 2022).
[20] Federal Reserve Board, Supervisory Guidance and Policy Topics (December 2022).

The Principles' focus on climate-related financial risk exposures of large financial institutions—those with over $100 billion in total consolidated assets—only tangentially addresses threats to the safety and soundness of smaller financial institutions, and, in turn, to fair access by marginalized communities to financial services these smaller institutions provide.

Climate change is increasingly and often permanently impacting homeowners, businesses, and infrastructure within certain geographies, causing escalating economic and financial losses. As borrowers and taxpayers struggle or fail to pay their bills, community banks and savings associations tied to those geographies face heightened safety and soundness concerns not faced by larger, geographically diversified financial institutions.

As explained in a recent Ceres report:

> Based on their local expertise, community banks tend to focus on a few key sectors, such as residential mortgages, commercial real estate (CRE), small business financing, and agricultural sector loans. Given this focus, community bank loan portfolios are more exposed to the physical risks of climate change considering the vulnerability of these sectors to acute weather events in the near term and transition risks in the medium to long term.[21]

The report observes there "are already examples of climate-related disasters that have fundamentally impacted the safety and soundness of community banks and credit unions.''[22] Hibernia Bank in Louisiana, for example, experienced $175 million in losses from Hurricane Katrina. A more recent analysis targeting credit unions reflects the same concerns.[23]

These concerns have only been heightened by the departure of insurers and reinsurers from climate-vulnerable areas. Nearly two dozen insurers have left Louisiana, and an even larger remaining number are no longer insuring in Louisiana's hotspot areas.[24] Insurers are similarly fleeing from Florida and other coastal states.[25] The implications likely are profound for smaller financial institutions supervised by the FRB that lend for home mortgages and commercial real estate in coastal states, including, for example, Alabama-based Regions Bank.

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[21] Ceres, Financing a Net Zero Economy: The Consequences of Physical Climate Risk for Banks, (Sept. 8, 2021).
[22] *Id.*
[23] Ceres, The Changing Climate for Credit Unions, (May 10, 2022).
[24] Rebekah Castor, More insurance companies pull out of Louisiana: 'We are in a crisis,' (January 2023).
[25] Mel Duval, Home insurers are leaving Florida: Here's what you need to know, (December 2022).

A 2020 report by the Climate-Related Market Risk Subcommittee of the U.S. Commodity Futures Trading Commission (CFTC report), describes such repeated "sub-systemic" shocks as initiating "*a systemic crisis in slow motion* (emphasis added)."[26]

Threats to the safety and soundness of regional and community banks raise novel challenges for developing effective risk management measures. Unlike large financial institutions, these banks cannot easily move or significantly shift portfolios; they exist primarily to serve local community needs. And even where they can, taking such measures would only further disadvantage the local communities that rely on them. The FRB cannot simply ignore these risks.

Nor does it have to. The FRB should consider how individual institutions are facilitating risks to the broader economy through their support for greenhouse gas (GHG) emitting activities. When individual institutions finance GHG emissions, they contribute to the increasing severity of global warming, fueling the economic damage described above. As small banks cannot always manage climate-related risks without risking severe damage to their communities, the FRB should assess how working with all financial institutions to manage their contribution to climate change can better mitigate those same risks (this approach is outlined in the *Trickle-down Climate Risk Regulation* editorial included in Appendix I to these comments).[27]

Such an approach is in line with the broader mandate the FRB has to protect the stability of the financial system. The Principles acknowledge a relationship between climate change and financial stability concerns, noting that climate risks may be propagated throughout the economy and financial system. Indeed, the Principles rightly define climate-related financial risks as a risk to the U.S. financial system and a threat to safe and sound banking and financial stability. As discussed above, in the context of climate-related financial risks, contagion can occur not only through a failure of large financial institutions and their links to other financial entities, but also through the interconnectedness of the environmental and financial systems and sub-systemic shocks related to this interconnectedness.

When financial institutions finance and facilitate fossil fuel-related activities and high-emitting projects, they heighten the creation of financial risks and resulting economic harms caused through connections between the environmental and financial systems. This is exactly what many large US financial institutions are doing. The Banking on Climate Chaos report and other studies have demonstrated that large US financial institutions, through their financing and facilitating of fossil fuel-related activities and other high-emitting projects, contribute

[26] Commodity Futures Trading Commission, Climate-Related Market Risk Advisory Subcommittee, Managing Risk in the U.S. Financial System, (Sept. 2020).
[27] Anne Perrault and Gael Giraud, Trickle-down Climate Risk Regulation. (September 2022).

significantly to GHG emissions and, in turn, exacerbate climate-related risks.[28] Similar to financial institutions' actions during the subprime mortgage crisis, those supporting fossil fuel-related activities are creating risks that other entities are left to deal with. The Principles should recognize that orderly reductions in such financing and support would meaningfully reduce threats to safety and soundness for all financial institutions — large and small — as well as the risks of impaired access to financial services for all communities and risks to the financial system.[29] The FRB should promote interagency action on these concerns.

IV. To be aligned with their public climate commitments, financial institutions' internal management strategies must follow climate science.

The Statement appropriately aligns the FRB with the OCC and the FDIC in recognizing the importance of financial institutions aligning their public climate commitments with their internal strategies. As detailed in a recent paper, *Supervising the Transition: How Banking Regulators Can Address the Coming Shift to Net-Zero Emissions,* transition plans and climate commitments are within the purview of bank regulation, and scrutiny of voluntary climate commitments detailed in the Statement is an important first step (*Supervising the Transition: How Banking Regulators Can Address the Coming Shift to Net-Zero Emissions* is included in Appendix I to these comments).[30] Climate commitments and transition plans can illuminate how well bank management understands climate-related financial risks and how effectively this group can implement a plan for handling such risk. To that end, the Statement is a welcome and needed start. But the FRB must complement this short pronouncement with more detailed guidance, as it falls far short of providing sufficient guidance for banks or examiners to assess whether a bank's commitments and internal strategies are aligned, or what risks are revealed by any misalignment. Given the wide adoption of net-zero commitments and the lagging development of transition plans, the FRB should provide detailed guidance on how it will assess alignment and how failure to achieve alignment raises concerns about a bank's management and asset quality.

The FRB should also not rely on banks meeting their voluntary commitments to manage transition risk. The passage of the Inflation Reduction Act (IRA), along with a package of California legislative and regulatory enactments in August 2022, constitutes a major government effort to reshape the economy, and will hasten the clean energy transition.

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[28] Rainforest Action Network, et al., Banking on Climate Chaos, (2022).
[29] David Arkush, Unsafe At Any Charge: Why Financial Regulators Should Actively Mitigate Climate-Related Risk, (May 26 2021).
[30] Yevgeny Shrago and David Arkush, Supervising the Transition: How Banking Regulators Can Address the Coming Shift to Net-Zero Emissions, (February 2023).

Modeling from the Princeton Net Zero Lab's REPEAT Project predicts that the IRA will significantly reduce emissions by 2030.[31] Coupled with state level policies, the IRA is likely to reshape the economic landscape for energy producers and consumers in the US, which is the type of transition risk that both banks' net-zero commitments and regulatory climate-related risk guidance are meant to address. The FRB should make sure banks are preparing for future disruptions instead of taking unnecessary risks for short-term gains.

Given the unpredictability and complexity of climate-related risk, the FRB can use well-settled authorities to encourage or require transition plans as a tool for minimizing the risks banks can control, and to create resilience for the risks they cannot anticipate. At the same time, the FRB and the FSOC have a financial stability mandate under the Dodd-Frank Act, and they have already recognized that climate change poses an emerging threat to financial stability. Transition plans can help address that mandate.

Further detail on how the FRB should implement its principle relating to the alignment of climate commitments and internal strategies is contained in the *Supervising the Transition: How Banking Regulators Can Address the Coming Shift to Net-Zero Emissions* paper, included in Appendix I.

V. The FRB should continue seeking alignment with global standards and best practices.

We encourage the FRB to use efforts by other central banks and by international standard setting entities as a guidepost for near-future action. Of particular importance are guidance and recommendations issued recently by the Basel Committee on Banking Supervision and the European Central Bank (ECB).

In December, the Basel Committee issued guidance clarifying how to incorporate climate-related financial risks into the existing Basel Framework on capital.[32] The guidance sets out standards for how regulators should incorporate climate-related financial risks into the existing Basel standards on prudential regulation. There are two key takeaways for the FRB.[33]

1. Large banks should incorporate climate-related risk into their capital adequacy assessments and stress testing.

[31] Jenkins et. al, Preliminary Report: The Climate and Energy Impacts of the Inflation Reduction Act of 2022. (August 2022).
[32] Basel Committee on Banking Supervision *supra* at 19.
[33] Yevgeny Shrago, Climate, Capital and Caution, (February 2023).

2. Banks should incorporate a margin of conservatism when assessing their exposure to climate-related risks, consistent with a precautionary approach.

The Basel Committee's role is to identify and recommend ways to address threats to bank safety and soundness and financial stability, mandates shared by the FRB. The committee has concluded that this should require banks to incorporate climate-related risk into their capital adequacy assessments and use a precautionary approach in assessing those risks. The FRB should follow suit.

The importance of these recommendations is further highlighted by the ECB's November 2022 conclusion that most banks are still far from meeting its climate-related risk management expectations.[34] In particular, the ECB found that most banks continue to underestimate the breadth and magnitude of the climate-related financial risks they face, and most have blind spots in identifying them. To address the lag by European banks, the ECB announced a set of staggered deadlines, culminating in an expectation of full compliance with its expectations by the end of 2024, four years after the ECB initially issued them. These expectations include full integration by banks of climate-related financial risks into their internal capital adequacy assessment process and stress testing, in line with the Basel Committee recommendations.

Unless the FRB has strong reason to believe otherwise, these findings from Europe should raise alarm bells about the risks faced by U.S. financial institutions, and the speed at which the FRB and other U.S. banking regulators are moving to address them. Despite almost two years of detailed supervisory expectations, European banks are still not adequately managing climate-related financial risks. U.S. banks have not even received this level of supervisory guidance, and there is no reason to assume their starting position is better than that of European banks. To defuse this ongoing threat to bank safety and soundness, it is imperative for the FRB to finalize the Statement and then quickly move to the more comprehensive plan for climate-related financial risk management described above.

These draft principles are much delayed compared to the efforts by the OCC and the FDIC, and they are much vaguer than the detailed expectations laid out by global peers and the Basel Committee on Banking Supervision.[35] Keeping in step with these domestic and international developments will promote financial stability by preventing regulatory arbitrage. The FRB should finalize these principles quickly and follow them with additional guidance and regulatory

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[34] European Central Bank Press Release, ECB Sets Deadlines for Banks to Deal with Climate Risks, (November 2022).

[35] Bank of England Prudential, Regulation Authority. Climate-related financial risk management and the role of capital requirements, Climate Change Adaptation Report, (October 2021).

measures that detail a full set of expectations and rules for all banks on identifying and mitigating climate-related financial risk.

We look forward to continuing to engage with you on these issues.

For questions, please contact Anne Perrault, at aperrault@citizen.org and Yevgeny Shrago, at yshrago@citizen.org.

Attachments:
Appendix I— *Public Citizen Comment on FDIC Principles for Climate Related Financial Risk Management*
Appendix II—*Looking Over the Horizon: The Case for Prioritizing Climate-related Risk Supervision of Banks*
Appendix III—*Trickle-down Financial Regulation, Science Editorial*
Appendix IV—*Supervising the Transition: How Banking Regulators Can Address the Coming Shift to Net-Zero Emissions*