Fact Sheet: DFS Climate Guidance for Banks and Mortgage Companies

In December 2022, New York's Department of Financial Services (DFS) proposed supervisory guidance on mitigating climate-related financial risks for New York-regulated domestic and foreign banks[1] and mortgage companies. DFS is the first financial regulator in the U.S., state or federal, to outline expectations on managing the effects of climate change and the energy transition for mortgage companies, as well as the first to do so for all banks under its authority, including small banks. This step recognizes the obvious: financial institutions, irrespective of their size or business line, will face impacts from climate change and the energy transition. The inclusion of mortgage companies is especially noteworthy because nonbank financial institutions are primarily overseen by state regulators. Additionally, the guidance provides an in-depth overview of how climate-related risks may manifest.

In 2021, DFS became the first state regulator to issue climate-related supervisory guidance for insurers. By expanding oversight to community banks and mortgage companies, DFS is solidifying its leadership in addressing the risks faced by the full range of institutions affected by climate change. Most importantly, DFS is attempting through its guidance to proactively mitigate the disproportionate impact of the climate crisis on low- and middle-income communities and communities of color. The proposed guidance calls on financial institutions to ensure fair access to credit and reminds small banks and mortgage companies of their community reinvestment obligations to promote climate resiliency.

What are the climate-related risks banks and mortgage companies face?

The proposed guidance provides a comprehensive overview of the two main types of climate-related financial risk:

- **Physical risks** stem from climate disasters and long-term changes to weather patterns. The increased frequency and intensity of hurricanes, floods, and wildfires may result in property destruction and high recovery costs. Chronic droughts, heat waves, and coastal erosion may lead to mass migration and reduced agricultural production. These compounding events may worsen economic

[1] Foreign bank branches licensed by New York are required to comply with state banking regulation. Since New York City is a major global financial hub, DFS plays a crucial role in overseeing foreign financial institutions.

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conditions and disrupt business operations for financial institutions and their clients. DFS's proposal stresses that banks' traditional usage of insurance to safeguard against physical risk may be insufficient. As insurance companies reduce coverage and increase premiums in high-risk areas, banks and mortgage companies may bear greater losses from climate-related disasters.

- **Transition risks** are driven by the shifts in technology, policy, and regulation intended to push an economy towards low-carbon solutions to the climate crisis. As the world moves toward a clean energy economy, carbon-intensive assets may substantially lose their value. Financial institutions operating in regions heavily dependent on carbon-intensive industries face the risk of declining incomes of their customers. This could lead to regional population outflows, which consequently, may reduce the value of a companies' investment and mortgage portfolios. The guidance notes that a disorderly economic transition to clean energy may hurt overall financial stability.

DFS is the first U.S. financial regulator to specifically outline the climate risks that nonbank mortgage companies face. Mortgage originators, who make loans, and mortgage servicers, who collect loan payments and handle defaults, are highly exposed to physical risks. Originators are exposed to decreased property values and challenges associated with repairing damaged properties before resale or transfer to investors. Servicers managing increased delinquencies due to climate disasters may face reduced revenue streams and higher staffing costs.

How does this guidance prioritize equity in climate-related risk management?

In the guidance, DFS urges financial institutions to take steps to minimize the disproportionate impacts of climate-related risk management on marginalized communities. The guidance specifically states that banks must not disinvest or raise the cost of credit in already underserved communities as part of their climate-related risk management. Low- and moderate-income ("LMI") communities and communities of color are more likely to be located in areas prone to flooding and extreme heat due to redlining and systemic racism. Financial institutions' climate-related risk mitigation may therefore unintentionally lead to reduced investment, coverage, and lending in these high-risk areas. DFS expects banks to actively identify and mitigate disproportionate impacts on marginalized communities as part of their initial lending decisions and ongoing monitoring of loan performance.

Keeping in mind the disparate impact of the climate crisis on marginalized communities, DFS encourages banks and mortgage lenders to extend green financing to promote climate resiliency through New York State's Community Reinvestment Act (CRA). LMI communities and communities of color have fewer resources to recover from the increasing frequency of climate disasters. As a result, DFS issued guidance on receiving credit for climate adaptation and climate mitigation financing activities under CRA. This includes financing for renewable energy, microgrid or battery storage, flood resilience activities, and energy-efficiency equipment in affordable housing. The current proposal reiterates the role of CRA-driven lending as a crucial tool to equitably mitigate climate-related financial risk.

What does the guidance tell banks and mortgage companies to do?

The proposed guidance notes that financial institutions already engage in risk management processes that can incorporate climate risk. Most of its recommendations align with those already made by federal banking regulators. DFS recommends building off of existing risk frameworks and developing new strategies, such as climate scenario analysis, to tackle the unique challenges of climate risk described above. Most importantly, DFS expects that each bank will set clear, measurable limits for climate-related risk and establish mitigation processes for when it takes on more risk than those limits allow.

DFS emphasizes the need for organization-wide capacity to address the harms of climate change and the transition to clean energy. From the bird's-eye view, senior management should understand the climate-related financial risks of the whole organization, especially how risks connect across business lines. At every stage of operations, risk management teams must be responsible and accountable for integrating climate risk into their internal processes. This means financial institutions must assess how climate change and the energy transition will impact new clients before any investment decisions are made.

Furthermore, the proposal echoes federal banking regulators in recognizing DFS's role in supervising financial institutions' voluntary climate commitments. DFS expects senior leaders' public statements on climate-related management to reflect their company's internal risk frameworks.

How will this guidance affect smaller financial institutions?

This guidance is the first time that a U.S. financial regulator has provided expectations for small financial institutions on climate-related risk management. This choice acknowledges that all financial institutions are exposed to the impacts of climate change and the shift to renewable energy. DFS notes that small companies are not shielded from climate risk due to their size. In fact, they are highly exposed to climate risks as a result of their lack of diversification across business lines and geographies.

DFS acknowledges that risk management practices must be proportionate to a company's size and complexity. The regulator accepts that mitigation will look different at small financial institutions compared to large banks, due to differences in both risk profiles and organizational capacities. As a result, the implementation of climate scenario analysis will vary based on an organization's size, complexity, and risk profile. The guidance recognizes that smaller financial institutions have fewer resources for risk management than large banks. However, rather than delay providing guidance to smaller institutions, the DFS proposal includes an ongoing, iterative process for climate scenario analysis to help small institutions identify their data and technological needs.

How does this differ from New York's insurance guidance?

The current guidance is missing two risk management expectations that were part of DFS's earlier climate risk guidance for insurers that could also apply to banking and mortgage institutions:

- Explicit acknowledgment that reducing financed greenhouse gas emissions in line with science-based targets is a good way to reduce climate-related risk.

- Requirements for financial institutions to publicly disclose, qualitatively and quantitatively, their exposure to climate risk and their strategies to mitigate this risk to promote greater transparency and accountability to the public.