



BANKERS' BANK OF THE WEST

Information on the FDIC and OCC Proposals for Climate-Related Risk

Bankers' Bank of the West tasked Peter Wharton, Business Coordinator, to develop and summarize a framework that community banks can utilize to better understand the Principles for Climate-Related Financial Risk Management proposals from the FDIC¹ and OCC². Currently, the proposed regulation would only impact large financial institutions with assets of \$100 billion or more, but smaller institutions can take proactive steps to address potential future regulation or regulatory expectation, while maintaining or enhancing their bottom lines.

1. What is the current issue and who is it affecting?

Climate change is an emerging threat to the financial stability of the United States. In the United States and across the globe, climate-related impacts in the form of warming temperatures, rising sea levels, droughts, wildfires, intensifying storms, and other climate-related events are already imposing significant costs on the public and the economy. Since the beginning of 2017, the total cost of U. S weather and climate disasters has exceeded \$690 billion, and in 2021 alone there were 20 climate disasters with losses exceeding \$1 Billion each affecting the United States according to the National Centers for Environmental Information³.

Jim Lochhead, CEO of Denver Water said concerning Colorado's water crisis, "This has been a 20-year train that we've known is coming, and now it's about to hit us. It's something all of us in the West need to be worried about."⁴

As a result of the continued rise in cost due to climate disasters, the United States has committed to lowering its greenhouse gas emissions by 50-52 percent from the 2005 levels by 2030 and set a goal of a net-zero emissions economy by 2050. While overall U.S. greenhouse gas emissions have been trending downwards since 2005, meeting these targets will require significant changes across the economy. Sectors of the economy that are greenhouse gas-intensive, which include the energy, transportation, manufacturing, and agricultural sectors, likely need to undergo significant structural changes. As a result of the climate crisis, the impacts of climate change on the U.S economy and the economic adjustments necessary to reduce greenhouse gas emissions present risks, as well as opportunities, to the financial system.

2. Why is this important, and what is happening to large and small financial institutions?

Emerging economic and financial risks associated with climate change that potentially threaten the safety and soundness of financial institutions. However, the ability to quickly attain, evaluate,

¹ <https://www.fdic.gov/news/board-matters/2022/2022-03-29-notational-fr.pdf>

² <https://www.occ.gov/news-issuances/bulletins/2021/bulletin-2021-62a.pdf>

³ National Centers for Environmental Information, Billion-Dollar Weather and Climate Disasters, <https://www.ncei.noaa.gov/access/billions>

⁴ Denver Business Journal, Thirsty for Change, July 1, 2022,

<https://www.bizjournals.com/denver/news/2022/07/01/drought-climate-water-colorado-river-conservation.html>

and implement data and solutions will help to understand the chaotic road to a less carbon-intensive economy. Not only is this important because it can help to reduce the carbon footprint and overall emissions but similarly can enable financial institutions to make more in-depth assumptions and better prepare for climate-related risks as they pertain to the financial institutions' assets, characteristics, and communities served.

This current issue affects all financial institutions as the United States continues its dependency on carbon and fossil fuels, creating greenhouse gases and other emissions. This inversely affects several natural environmental processes such as rising sea-levels and global temperatures. An increase in irregular weather patterns and more destructive events resulting from warmer temperatures and overall global emissions, financial institutions and their surrounding communities will be negatively affected because of the physical and transition risks associated with climate change, which could result in the rapid repricing of assets.

Community banks are still affected by climate change, but unlike , much unlike their large regional and national financial institution counterparts, they operate in much smaller markets where localized impacts can be much more drastic and influential as it potentially affects the largest pieces of their portfolios. As a result, gaining and understanding of, and even implanting some, climate-related risk practices enable community banks to prepare for potential legislation or regulation in addition to environmental impacts. This proactive approach further positions community banks to mitigate some extreme climate-related risks and continue supporting their communities and the people within them.

Climate-related risks can be viewed from two lenses:

- Physical risks cover those events that impact the premises and operations of the financial institution, its customers, and the wider economy. They include extreme weather events and long-term shifts in climate leading to the closing of retail branches or facilities, negatively impacting the creditworthiness of clients, and adversely affecting asset prices.
- Transition risks, on the other hand, cover those events that impact a financial institution's products and services because of the move toward a lower-carbon economy. They include the extent to which financial institutions fund or have a stake in companies that emit greenhouse gases, evolving stakeholder expectations (e.g., consumers being more environmentally motivated), and associated legal or regulatory changes.

Understanding these risks as it pertains to climate change will benefit financial institutions as they work to address climate-related financial risks and the corresponding impacts.

While not climate specific, the NYU Stern Center for Sustainable Business and Rockefeller Asset Management collaborated⁵ to examine the relationship between Environmental, Social, and Governance (ESG) and financial performance in more than 1,000 research papers from 2015–2020. The results found a positive relationship between ESG and financial performance for 58% of the “corporate” studies focused on operational metrics such as ROE, ROA, or stock price with 13% showing neutral impact, 21% mixed results (the same study finding a positive, neutral

⁵ NYU Stern Center for Sustainable Business and Rockefeller Asset Management, ESG and Financial Performance, https://www.stern.nyu.edu/sites/default/files/assets/documents/NYU-RAM_ESG-Paper_2021%20Rev_0.pdf

or negative results) and only 8% showing a negative relationship. As a result, the authors drew six conclusions about the relationship between ESG and financial performance after examining the 1000 plus individual studies.

- Improved financial performance due to ESG becomes more marked over longer time horizons.
- ESG integration, broadly speaking as an investment strategy, seems to perform better than negative screening approaches. A recently released Rockefeller Asset Management study finds that ESG integration will increasingly be demarcated between “Leaders” and “Improvers” with the latter showing uncorrelated alpha-enhancing potential over the long-term (Clark & Lalit, 2020).
- ESG investing appears to provide downside protection, especially during a social or economic crisis.
- Sustainability initiatives at corporations appear to drive better financial performance due to mediating factors such as improved risk management and more innovation.
- Studies indicate that managing for a low carbon future improves financial performance.
- ESG disclosure on its own does not drive financial performance.



3. What is the proposal for large financial institutions by the FDIC and the OCC?

The climate-related financial risk management plans presented by both the FDIC and OCC target financial institutions with \$100 billion or more in assets, focusing on their climate-related financial risk management and practices. These practices center around implementing sound governance to demonstrate an appropriate understanding of climate-related financial risk exposures. Once sound governance is created, including the involvement of the board and management, the financial institution can then focus on implementing policies, procedures, and limits as they pertain to climate-related risks and the specific financial institution's activities.

Using scenario analysis⁶, the financial institution can identify, measure, and manage climate-related risks as they apply to the institution. Scenario analysis further enables a financial institution to conduct a forward-looking assessment of the potential impact on an institution from changes in the economy, financial system, or the distribution of physical hazards resulting from climate-related risks. This in turn can give the financial institution the ability to observe and review how climate scenarios can differ and what their impacts can be on the financial institution's assets and risk management practices due to the changing climate.

4. How does this relate to community banks?

The FDIC and the OCC have advised that community banks delay full implementation until more information and knowledge is available to follow these specific guidelines. However, that does not mean community banks cannot begin looking at and attempting to understand potential climate change challenges.

This can be accomplished by looking at their internal risk assessment to conceptualize where and how much risk could vary according to climate change in the communities they live in and support. By utilizing a scaled-down version of scenario analysis, a community bank could evaluate at several scenarios, such as an increase in average temperatures of 0.5° Celsius to 2° Celsius, observing the associated risks with them.

Such an analysis would help community banks gain knowledge of their climate-related risk and associated characteristics as it pertains to their specific institution and market. Although the national policy is much further along than that of the community policies, community banks can still make immediate progress to create a low-carbon economy for the future.

5. What are some recommendations for community banks address climate-related financial risks and attempt to mitigate environmental impacts for themselves?

- Implement sustainable practices in facilities, such as installing automated lights, sinks, and toilets, obtain LEED or Green Building Certifications by retrofitting or upgrading systems to reduce energy and water consumption and gain efficiencies. This can include sourcing energy usage from a renewable source or pursuing grants and credits to assist with such changes (e.g., solar panel and xeriscape incentives).

⁶Task Force on Climate-Related Financial Disclosures, The Use of Scenario Analysis in Disclosure of Climate-related Risks and Opportunities, <https://www.tcfhub.org/scenario-analysis>

- Reduce consumables or shift to renewable products used within the financial institution (e.g., shifting paper to green paper products or reduce the usage by shifting to going electronic).
 - A 2008 PayItGreen Alliance survey⁷ vetted by the Environmental Protection Agency found that an American household could save 6.6 pounds of paper, 63 gallons of water, and 4.5 gallons of fuel per year by choosing to receive paperless statements and bills.
- Review the potential climate-related risk as it pertains to your financial institutions' current risk portfolio. Utilizing scenario analysis to evaluate multiple approaches.
- One method to becoming an eco-friendlier financial institution is to limit exposure to companies who participate in environmental degradation, which could include divesting of some current assets. Alternatively, investing in companies that are moving focus to renewables is a method to balancing exposure and providing growth opportunities.
 - However, this can be taken too far, for example, Bank of the West has defined its Prohibited Practices as tobacco, arctic drilling, and fracking, with Restricted Practices including coal power, palm oil, and wood pulp, and Protecting Practices as ocean health.
- Attain your B-Corporation Certification⁸, which are “businesses that meet the highest standards of verified social and environmental performance, public transparency, and legal accountability to balance profit and purpose.”
- Pursue other certifications/ groups such as the Global Alliance for Banking on Values (GABV)⁹, a network of independent financial institutions using finance to deliver sustainable economic, social, and environmental development.
- Support, sponsor, or partner with environmental companies: (e.g., Protect Our Winters, 1% for the Planet, The Conservation Alliance, One World Environment).
- Develop a marketing plan to demonstrate the approach to managing its climate-related risk.

Conclusion

Community banks who understand the challenges and proactively engage in climate-related risk practices will be better equipped to plan for the effects of climate change in their smaller communities, where the consequences could be more drastic if they affect the largest portion of the bank's portfolio. Moreover, steps taken now might not only cost less to implement but could generate further efficiencies and cost savings in the long run.

Peter Wharton holds a bachelor's degree in environmental studies with minors in geology and general business from the University of Colorado. In his role at BBW, he has been exploring the new FDIC and OCC climate-related risk frameworks as they pertain to financial institutions. This summary is meant to provide a platform for future exploration of related issues.

⁷Independent Banker, How Going Green Can Help the Planet and Your Bank, March 1, 2021, March <https://independentbanker.org/2021/03/how-going-green-can-help-the-planet-and-your-bank>

⁸B Lab, Measuring a Company's Entire Social and Environmental Impact, <https://www.bcorporation.net/en-us/certification>

⁹Global Alliance for Banking on Values (GABV), <https://www.gabv.org>