Finance Watch comments the on Federal Deposit Insurance Corporation Statement of Principles for Climate-Related Financial Risk Management for Large Financial Institutions

Opening Comment
Finance Watch welcomes the FDIC work on the principles for climate-related financial risk management, which recognizes the challenges faced by banks and supervisors alike in this area. However, our feedback outlines that principles-based guidance for supervisors and financial institutions will not be sufficient to achieve timely and impactful outcomes in managing climate-related financial risks of financial institutions. In addition to the principles, further measures are needed, taking a precautionary approach to tackling these risks. This can and should be done as part of the holistic review of bank prudential regulation and priority should be given to the concrete, impactful and immediately feasible measures. Detailed points on addressing climate-related financial risks can be found in our recent report “A silver bullet against green swans”.1

A. Applicability
Question 1: What additional factors, for example asset size, location, and business model, should inform financial institutions’ adoption of these principles?

The principles should be adopted with as large a scope as possible, given the financial implications of climate change for all financial institutions. There can still be significant implications from financial institutions of smaller sizes on customers and for the economy if they are not properly managing climate-related financial risks. Whilst smaller financial institutions may not pose the same systemic level of risk on their own, impacts from climate-related financial risks will be materializing at similar times for all banks and could make a collective of smaller banks very systemically significant. Furthermore, in order to ensure customer/depositor protection, all financial institutions should be obliged to run sound risk identification and management processes.

As financial institutions have both micro and macro level exposure to climate-related financial risks, it is important to ensure wide application of the principles. There is otherwise a potential for large financial institutions to reduce micro-prudential risks, but for these risks to still be systemic through macro level exposure in case risk reduction happens through “offloading” the risks to other financial institutions or state entities without risk reduction at the systemic level.

An example would be the financing or insuring of the fossil fuel sector. This sector exposes financial institutions to high transition risk at a micro level. Financing and ensuring the sector also accelerates climate change. This increases exposure to physical risk at a macro level.

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1 Symon, Julia, A silver bullet against green swans: Incorporating climate-related financial risk into bank and insurance prudential rules, November 2021.
B. Tailoring

Question 2: How could future guidance assist a financial institution in developing its climate-related financial risk management practices commensurate to its size, complexity, risk profile, and scope of operations?

Whilst developing future guidance on proportionate risk management practices will be important, what is most urgently needed is federal level regulation to ensure that financial institutions take a holistic approach to integrating climate-related financial risk. An underlying principle for the assessment of proportionality must be to ensure that risk is still properly managed and not to create a deregulatory agenda that transfers risk to clients or citizens to reduce administrative burden. The FDIC should use its role on the FSOC Board to recommend upgrading existing regulation to explicitly address climate-related financial risk.

Given the global nature of climate change, its impact and the interconnectedness of financial markets, international coordination on minimum regulatory and supervisory requirements is also both justified and needed.

C. General

Question 3: What challenges do financial institutions face in incorporating these draft principles into their risk management systems? How should the FDIC further engage with financial institutions to understand those challenges?

Climate-related financial risks have specific features, which pose significant challenges when it comes to deploying existing prudential tools and approaches to tackle them.2 Specifically:

- Disruption risk: Climate-related events are defined as “green swans” and have specific features, which makes them impossible to predict and model. In particular, green swans are characterized by: i) certainty of their occurrence despite highly uncertain impacts and the impossibility to determine the exact timing of their materialization; ii) wide-ranging and existential impacts on the economy and the financial system; iii) a high degree of complexity, including cascade effects and chain reactions in the environment, economy and society.

- Probabilities of climate-related events not reflected in past data: Traditional risk modeling based on historical data is not possible as we are dealing with a forward-looking phenomenon, for which no past data can be used reliably to extrapolate the future. By definition, when the data eventually arrives, it will be too late to avert a global climate change-induced financial crisis.

- Growing risk with prolonged inaction: The magnitude and probability of climate change materialization are increasing as long as no tangible actions are taken to reduce

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greenhouse gas emissions. Once global temperatures have exceeded their pre-industrial level by 2°C, the consequences on human society and the global economy will be irreversible and largely unpredictable.

- The time horizon of climate-related financial risks materialization can be significantly longer than the horizon of the current business forecasting, planning and risk management frameworks. This poses additional challenges for financial institutions to appropriately incorporate climate-related financial risks into management practices.

- Environmental stability, including climate, is by nature a public good, which comes at no cost to private agents. Coupled with the long materialization horizons of climate-related financial risks, this means that businesses and financial institutions do not have incentives to consider the implications of their activities for the environment/climate. Looking after public good is the mission of governments/regulators, not private agents.

Due to these specific features of climate-related financial risks, no credible methodologies or tools have been developed yet to accurately identify and assess or measure these risks. The Basel Committee on Banking Supervision (BCBS) published two reports in April 2021 outlining numerous challenges and conceptual issues related to climate risk measurement and methodologies. The most notable of these include the specific features of climate-related financial risks (as was mentioned in Section 2 above), data gaps, difficulties to translate climate-related events into financial impacts on institutions’ portfolios (climate risk drivers and transmission channels).

Question 4: Would regulations or guidelines prescribing particular risk management practices be helpful to financial institutions as they adjust to doing business in a changing climate?

As outlined in the response to question 2, a holistic regulatory approach to integrating climate-related financial risk should be taken. This should include adjusting capital requirements for sectors that are proven to pose high transition risk due to asset stranding as countries move towards their climate commitments/objectives. The clear starting point here is the fossil fuel sector, where the scientific case on their impact on climate change and risk of stranded assets has been clearly made, including in the recent Intergovernmental Panel on Climate Change (IPCC) report. This provides sufficient evidence and justification to realign capital treatment of fossil fuel assets, to treat them as posing the highest levels of risk under existing regulatory frameworks. Differentiation should be made between exposures to existing fossil fuel reserves, as the assets associated with those will increasingly depreciate as reaching net zero by 2050 requires pre-determined reductions in the fossil fuel consumption; and exposures to new fossil fuel exploration and expansion of the existing reserves, as there is no room for those activities on the net zero trajectory. Based on this logic, fossil fuel related exposures should be either subject to the highest credit risk capital charges under the existing prudential rules (exposures

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3 IPCC Sixth Assessment Report, Climate Change 2022: Mitigation of Climate Change, the Working Group III contribution, 4 April 2022.

to existing reserves) or to full equity funding requirement (exposures to reserve expansion and exploration; this equates to 1250% credit risk weight under the Basel framework).

The same logic should be applied and expanded where possible to other sectors posing proven high levels of climate-related financial risk based on the objectives of transition.

In addition, financial institutions should be required to undertake transition planning, as a risk management process, which should include setting transition objectives and intermediate targets. Transition plans and progress to achieving the targets they work towards should be monitored and assessed as part of supervisory review processes. In addition, financial institutions should set sustainability targets that are linked to the variable remuneration of directors. This would ensure a more comprehensive approach to integrating climate-related financial risk into risk management processes.

D. Current Risk Management Practices

Question 5: What specific tools or strategies have financial institutions used to successfully incorporate climate-related financial risks into their risk management frameworks?

So far the approaches taken by financial institutions to incorporate climate-related financial risk have been limited. The current high levels of financial performance of the sectors such as fossil fuels (which are due, among others, to the fact that financial agents are not able to properly price climate-related financial risks, as well as inherent short-termism of financial markets), combined with limited political action to address climate change lead financial institutions to focus on shorter term gains. This relies on a brinkmanship approach, where these financial institutions hope to be able to divest and quickly adapt when transition risk or physical risk materialize. The danger lies in the unpredictable, accelerating and irreversible nature of climate change, which cannot be accurately modeled as things stand. This leaves financial institutions with a limited view to the horizon and an incentive to try to extract short term profits from activity that increases risk at both a micro and macro level.

In addition, internal and external credit ratings for fossil fuel assets do not take into account transition, physical or disruption risk, meaning that there is an effective risk subsidy in place. Capital requirements cannot be properly calibrated to cover the risk in this case, unless specific updates to existing prudential rules are introduced. Until this underlying issue is dealt with, other measures unfortunately are closer to window-dressing than risk management.

This conclusion is supported by the results of the European Central Bank (ECB) assessment of the banks’ current progress on Pillar II measures, whereby the ECB has concluded that banks’ current practices fall short of supervisory expectations.5 Banks were found to be “not yet in a position to identify, manage and monitor [climate and environmental] risks at counterparty level”. Also the banks’ plans to set a framework for climate management do not

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5 ECB Guide on climate-related and environmental risks setting supervisory expectations relating to risk management and disclosure has been in place since November 2020.
yet ensure that most banks can properly manage these risks.6 The study by BlackRock Financial Markets Advisory on “Development of tools and mechanisms for the integration of Environmental Social and Governance (ESG) factors into the EU banking prudential framework and into banks' business strategies and investment policies” also concluded that “integration of ESG within banks’ risk management and investment practices, as well as prudential supervision, is at an early stage” and “needs to be accelerated”.7

**Question 6: How do financial institutions determine when climate-related financial risks are material and warrant greater than routine attention by the board and management?**

Operationalization of the traditional guidance on materiality assessment represents a major issue in the case of climate-related financial risks, as there is significant level of uncertainty associated with climate-related risks, insufficient availability, as well as standardization and consistency of data with which to analyze and measure these risks. Transmission channels between climate events and financial implications for the balance sheets of affected institutions require further exploration before these are fully understood.

The fact that the FDIC considers only financial materiality is a significant gap in its approach to the interaction between climate change and financial institutions. Financial materiality is of course essential, but when it comes to climate change financial materiality is fed by environmental materiality. In other words, attempting to address financial materiality without addressing environmental materiality is tantamount to deciding to ignore the root causes of climate-related financial risks. A doom loop exists by which financial institutions, and in particular banking institutions, make climate change possible by providing financing to the fossil fuel industry, which is at the source of the bulk of CO2 emissions. At the same time, financial institutions are themselves threatened by climate change. The lack of consideration of the double materiality approach by the FDIC hinders its ability to develop appropriate policies to tackle the vicious circle between climate change-enhancing financing and risks that it represents to the financial institutions.

**Question 8: What, if any, specific products, practices, and strategies—for example, insurance or derivatives contracts or other capital market instruments—do financial institutions use to hedge, transfer, or mitigate climate-related financial risks?**

It is important to note here that while financial institutions might be able to use certain strategies to hedge or transfer risks on an individual level, from the systemic perspective the risk is not reduced as long as climate change is not abated globally. A financial institution with a satisfactory carbon balance does not mean that its climate risk is reduced. This risk is systemic

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6 ECB, The clock is ticking for banks to manage climate and environmental risks, Supervision Newsletter, 18 August 2021.
7 BlackRock Financial Markets Advisory, Development of tools and mechanisms for the integration of ESG factors into the EU banking prudential framework and into banks’ business strategies and investment policies, Final Study, May 2021 (published 27 August 2021); Executive Summary, p. 3, 7.
in nature and is only reduced by the sum of the individual and combined actions of all financial and economic actors and at the same time. This is why coordinated actions of international supervisors and public authorities in all jurisdictions are fundamental.

**Question 9:** What, if any, climate-related financial products or services— for example, “green bonds,” derivatives, dedicated investment funds, or other instruments that take climate-related considerations into account—do financial institutions offer to clients and customers? What risks, if any, do these products or services pose?

There is a significant risk of greenwashing and risk-washing with existing products and services. A first key issue is that the current definitions of sustainable are questionable and mostly unregulated. This can lead to them being very broad and not necessarily having any measurable positive impact on climate change mitigation or adaptation that could be considered as risk mitigating. This is not to speak to the intentions behind the efforts that take place around the creation of sustainable definitions, but rather simply to their robustness for risk measurement purposes.

ESG ratings of financial instruments and entities, which have become wide-spread suffer from a number of drawbacks such as lack of transparency around the data and methodologies they use, lack of clarity around their scope and purpose (e.g. if these rating capture only ESG risks, which are financially material, or also ESG impacts, which might not be material to the risk profile of the entity/instrument immediately, but might contribute to the risks in the system), lack of data verification/validation and reliance on the data provided by the entities themselves. As a result, there is a significant gap between what is assessed by ESG ratings and data products and what is assumed (or implied) to be assessed, or what should be assessed in order to improve investors’ contribution to achieving climate change mitigation in line with the Paris climate commitments.

A further key issue is over the capacity of certain financial instruments to have an impact on the real economy. Some financial instruments follow financial performance and exist as ‘synthetic’ products without any capacity to directly impact economic activity. They are not capable of having a positive impact of climate change that could be considered as risk mitigating.

For the key reasons outlined above there is a real issue over potential risk-washing where greenwashing (intentional or not) is taking place.

**E. Data, Disclosures, and Reporting**

**Question 11:** What, if any, specific climate-related data, metrics, tools and models from borrowers and other counterparties do financial institutions need to identify, measure, monitor, and control their own climate-related financial risks? How do financial institutions currently obtain this information? What gaps and other concerns are there with respect to these data, metrics, tools or models?
There is currently a significant lack of data and climate models and metrics are still very much under development. There are too many uncertainties over exactly when and how the impacts of climate change will materialize. This means it is still not possible to quantify climate-related financial risks. The process of properly developing these models, metrics, tools, developing indicators and collecting data should continue to try and reach this goal with the degree of accuracy possible, whilst realizing that due to the specific features of climate-related financial risks, as outlined above, modeling these risks will likely never be possible with sufficient degree of precision.

Data provided by ESG rating and data providers are increasingly being used as a source of climate-related information. However, the challenges, which we mentioned in the response to Question 10, contribute to opacity of the ESG ratings, which is compounded by the lack of standardization and consistency of underlying data, for which no established accounting standards are yet in place (in contrast to information from firms' financial statements that informs credit ratings). In its report “The Availability of Data with Which to Monitor and Assess Climate-Related Risks to Financial Stability”, the Financial Stability Board warned against using the ESG ratings as a source of climate-related information at this stage. This suggests a need to accelerate international work on establishing possibly aligned data definitions and metrics for the ESG, in particular climate-related data.

In the meantime, action is needed to address the absolute and scientifically asserted certainty that climate change is and will have devastating impacts that will either require or force significant changes to financial markets and economies. Either through a managed transition or disruption as a result of climate change-related events. This certainty must form the basis for taking regulatory action to ensure that climate-related financial risks are not threatening financial stability and creating a pocket of untreated risk.

**Question 12: How could existing regulatory reporting requirements be augmented to better capture financial institutions’ exposure to climate-related financial risks?**

Financial institutions can have an important role in the transition to a more sustainable economy. They can use this role to mitigate their own exposure to transition risk, as well as in turn reduce activities that contribute negatively to climate change. By extension this then mitigates physical and disruption risks. Some large financial institutions are already starting to make public commitments to divest from fossil fuels that do not start actively planning and proving that they are transitioning.

There is an implied role for supervisors here to ensure the standardization and validity of information relevant to financial markets provided by financial institutions. This role should become more explicit and give supervisors an active mandate to set science-based standards

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and methodologies for alignment of financial institutions’ portfolios with the Paris agreement goals, transition pathways towards these goals and monitor their implementation, to ensure that financial institutions set credible transition goals and stick to them. Please also refer to the response to question 4 here.

There is also a need to move towards internationally aligned standards on sustainability-related disclosures. The work of the ISSB, the SEC and the EFRAG will not be effective if each jurisdiction creates different and incompatible frameworks. The starting point for standards must take a double materiality approach as a basis for creating comparable information and a common set of definitions and recognized metrics. Properly aligned standards would ensure that the sustainability-related information needed for transition planning is available and that disclosures are as meaningful as possible. This in turn is important to ensuring that transition plans and sustainability targets are integrated into risk management processes.

F. Scenario Analysis

Question 13: Scenario analysis is an important component of climate risk management that requires assumptions about plausible future states of the world. How do financial institutions use climate scenario models, analysis, or tools and what challenges do they face?

Please see our response to Question 14.

Question 14: What factors are most salient for the FDIC to consider when designing and executing scenario analysis exercises?

The world’s leading supervisors have put a lot of value on climate “stress tests” as a tool to identify and manage climate-related financial risks across the financial system. These stress tests have effectively been scenario analysis exercises so far. The results of these exercises do offer valuable insights into the climate-risks of financial institutions and potential channels and effects of their materialization. These insights in turn help shape supervisors’ actions and also raise awareness among financial institutions to enhance their risk management practices and adapt business models. However, there are significant limitations to the so-called “stress tests”, which can be found in Finance Watch’s report “A silver bullet against green swans”.9

A fundamental point that needs to be further explored is the transmission channels between climate events and financial implications for the balance sheets/capital of affected institutions. As the BCBS report from April 2021 highlighted, “Existing analysis does not generally translate changes in climate-related variables into changes in banks’ credit, market, liquidity or operational risk exposures or bank balance sheet losses. Instead, the focus is on how specific climate risk drivers can impact narrowly defined sectors of particular economies, individual

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9 Symon, Julia, A silver bullet against green swans: Incorporating climate-related financial risk into bank and insurance prudential rules, November 2021.
markets, or top-down assessments of the macro economy as a whole”. The report concludes that significant further research and empirical evidence are required. The European Banking Authority (EBA) pilot exercise on identifying and mapping climate risks in the banks’ portfolios reached similar conclusions.

A key issue is that existing scenarios do not take into account the feedback loop, i.e. the impact which the financial sector itself has on transition and climate developments. There can be scenarios where the financial system plays a hampering role in transition so that the resulting impacts of scenarios (risks) might be underestimated. The ECB has made progress to overcome some of those challenges in its EU-wide stress test exercise; however, the ECB also outlined that a significant amount of work is yet to be undertaken towards “a comprehensive climate stress-testing framework”. The limitations of climate scenario exercises were confirmed by the Network for Greening the Financial System (NGFS) based on the experience of 30 central banks and supervisors across the world.

Importantly, “stress tests” have not yet led to and were not even intended to lead to conclusions about the capital adequacy of the financial institutions assessed. Therefore, these “stress tests” should be regarded as pilot exercises of exploratory nature. So far, only the ECB has considered the possibility of imposing qualitative or quantitative requirements on a case-by-case basis on the results of its supervisory review.

10 BCBS, Climate-related risk drivers and their transmission channels, April 2021, p. 2.
11 EBA, Mapping climate risk: Main findings from the EU-wide pilot exercise, 21 May 2021.
12 S. Alogoskoufis, N. Dunz et al, ECB economy-wide climate stress test: Methodology and results, ECB Occasional Paper Series, No 281, September 2021, p. 64-67. Some of the most notable of advancements have been the following: i) analysis of banks’ credit and market portfolios at exposure level, thus accounting for firm-specific vulnerabilities to climate risk factors; ii) capturing key transmission channels of climate risks by means of employing models specifically developed for the exercise; iii) analysis of the interactions between physical and transmission risks. Yet, with reference to the identified limitations, the following avenues of future work have been outlined in the ECB report: i) modeling of the banks’ endogenous reactions and their feedback loop to real economy; ii) consideration of additional physical risk hazards; iii) inclusion of additional sets of bank portfolios such as retail portfolio, which could not be considered due to lack of sufficient data or of sufficient granularity; iv) modeling contagion dynamics in the financing sector that could amplify the impact of climate risks.