

VIA EMAIL

Martin J. Gruenberg
Acting Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Re: Principles for Climate-Related Financial Risk Management for
Large Financial Institutions (RN 3064-ZA32)

Dear Acting Chairman Gruenberg:

On behalf of the Natural Resources Defense Council (NRDC), we are pleased to submit these comments on the draft Principles for Climate-Related Financial Risk Management for Large Financial Institutions issued by the Federal Deposit Insurance Corporation (FDIC). NRDC is an international nonprofit environmental organization with more than 3 million members and online activists. Since 1970, our lawyers, scientists, and other environmental specialists have worked to protect the world's natural resources, public health, and environment. NRDC has offices in New York City, Washington D.C., Los Angeles, San Francisco, Chicago, Montana, and Beijing. Through its finance and legal experts, NRDC remains engaged in financial regulation and views sensible financial regulation as an integral part of mitigating climate change.

We appreciate the FDIC's leadership on this important first step to integrate climate-related financial risk into its prudential supervision of large banks. Climate change presents a serious threat to individual banks and to the financial system. Banks should be encouraged to identify and mitigate climate-related financial risk and supervisory guidance from the FDIC will ensure that banks will rigorously undertake these efforts.

The Introduction section of the *Principles* cogently describes the emerging threat to individual financial institutions and to the financial system posed by climate change, both from physical risk and from transition risk. We therefore proceed directly to addressing some of the questions posed by the RFI.

Questions 1, 2, and 3: Additional factors, for example, size, location, and business model, that should inform institutions' adoption of principles; how could future guidance assist a financial institution in adopting risk management practices

commensurate to its size, complexity, risk profile, and scope of operations; and what challenges do institutions face in so adopting and how can the FDIC help?

The *Principles* are directed at financial institutions with over \$100 billion in total consolidated assets. Ultimately, as the FDIC appears to recognize, guidance must be developed to apply to virtually all institutions; the FDIC supervises and examines about 5,000 banks and savings associations. However, the requirements will presumably be tailored to take into account the institution's size as well as other considerations.

We understand why the FDIC might choose, as a first step, to address the guidance only to the largest institutions. These larger institutions have more internal resources to develop the robust governance and operational procedures necessary to address climate-related financial risk, as well as purchase the data needed to fully consider the risk to their portfolios. But it is important that the FDIC follow up promptly with a timeframe and then the actual issuance of guidance for smaller banks, appropriately tailored to their situations. The *Principles* put smaller banks on notice that climate risk guidance applicable to them will be forthcoming. A more specific timeframe for complying with such guidance will assist smaller banks in beginning internal preparations for compliance and the actual issuance of tailored guidance will allow them to complete their preparations. It is not too soon to start thinking about the guidance that would apply to smaller institutions. There are two factors that stand out when considering how to craft guidance for the smaller institutions.

First, their risk profile may be very different from that of larger institutions. They may have far greater concentration risk, including industry and geographic concentrations. For example, a large percentage of their loan portfolio might consist of loans to farmers with outsize drought risk, to coastal property owners with worsening hurricane and flooding exposure, or to fossil fuel businesses jeopardized by transition risk.

From an institutional safety and soundness perspective, it is important to identify these concentration risks. Portfolio diversification may be difficult without impairing the institution's mission of serving the local community. This issue may be particularly acute for low-to-moderate (LMI) or disadvantaged communities. The second difference is that smaller institutions will tend to have fewer internal resources to address climate-related financial risk. They have a smaller portfolio over which to spread fixed costs such as hiring personnel to deal with climate issues.

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?

NRDC agrees that banks can use insurance and derivatives to mitigate climate-related financial risks, but there is a danger of solely relying on such measures to mitigate these risks.

Banks require insurance coverage to mitigate potential losses due to any loss event, including climate disasters. However, risks from both the insured and/or the insurer could revert the climate-related risks to the banks themselves.

Borrowers are required to provide proof of insurance coverage for loan closing purposes. However, as regions prone to climate change effects are subject to increased risk pricing, higher premiums (or worse, the discontinuation of coverage) can lead to a lapse in coverage for borrowers in these areas. These lapses in coverage can be overlooked due to the loose enforcement of maintaining the required coverage.

Counterparty risk could also swell during climate disasters as the insurers themselves are highly susceptible to climate-related risks. Many insurers invest their assets in investments vulnerable to climate disasters or transition risk. Climate events could drain the liquidity of asset pools used for payouts. Moreover, improperly assessed climate risks can lead to insufficient payouts as risk assessment maps of disaster-prone regions are not up to date.

Question 10: How do financial institutions currently consider the impacts of climate-related financial risk mitigation strategies and financial products on households and communities, specifically LMI and other disadvantaged communities? Should the agencies modify existing regulations and guidance, such as those associated with the Community Reinvestment Act, to address the impact climate-related financial risks may have on LMI and other disadvantaged communities?

NRDC agrees that banks must be encouraged to consider the fair lending implications of their climate risk strategies. As outlined below, there is a real danger that the adoption of enhanced climate risk mitigation measures by banks may result in disproportionate treatment of or impact to climate-burdened communities, including lower-income communities and communities of color. We urge FDIC to consider additional regulatory actions to address likely impacts on disadvantaged communities.

Fair lending laws prohibit banks from engaging in discriminatory lending practices.¹ There are two categories of discriminatory practices for fair lending purposes. *Disparate treatment* occurs when a lender treats a borrower differently based on a proscribed characteristic, such as race or sex. *Disparate impact* occurs when a facially neutral policy or practice disproportionately burdens a protected class of persons.² If a disparate impact exists, the lender must show that the policy or practice is justified by “business necessity.” Even if a business necessity exists, however, the lender may be liable if there are alternative policies that serve the same purpose with less discriminatory effect.³

Fair lending risk is especially acute where risks are distributed unevenly among potential borrowers in a manner that aligns with one or more protected characteristics, such as race. Climate change fits squarely within this category. A substantial and growing literature demonstrates that many climate-related risks, such as the risk of weather-induced disaster or sea level rise, may be disproportionately borne by lower income communities and communities of color.⁴ A November 2021 Staff Report by the Federal Reserve Bank of New York surveyed this literature and concluded that “regions of the United States that are home to above-average shares of low-income and minority groups are likely to suffer the greatest meteorological effects of climate change.”⁵ The report also found that “low-income and minority Americans are limited in how they may adapt to climate change because they have less access to insurance and are less likely to have access to credit when needed.”⁶

The close correlation between climate and race (among other factors) raises the possibility that bank policies and practices intended to mitigate climate risk may create fair lending liability through disparate treatment of or disparate impacts on borrowers of color. Moreover, even where bank practices do not give rise to legal liability under fair lending laws, they may unreasonably restrict access to financial services within climate-burdened communities.

¹ 15 U.S.C. § 1691(a); 42 U.S.C. § 3605(a). The Equal Credit Opportunity Act proscribes discrimination on the basis of race or color, religion, national origin, sex, marital status, age, source of income, or attempted exercise of consumer rights. The Fair Housing Act proscribed discrimination on the basis of race or color, national origin, religion, sex, familial status, or handicap. *Id.*

² See Regulation B, 12 CFR Part 1002, Comment 6(a); 24 CFR 100 s 100.500.

³ *Id.*; see also Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Reserve Board, Office of Thrift Supervision, and National Credit Union Administration, Interagency Fair Lending Examination Procedures (August 2009).

⁴ See, e.g., Buchanan, Maya K., Scott Kulp, Lara Cushing, Rachel Morello-Frosch, Todd Nedwick, and Benjamin Strauss. “Sea Level Rise and Coastal Flooding Threaten Affordable Housing.” *Environmental Research Letters* 15, no. 12 (2020): 124020; Keenan, Jesse, and Elizabeth Mattiuzzi. “Climate Adaptation Investment and the Community Reinvestment Act.” *Community Development Research Brief* 05 (2019): 01-30; Furman Center, Population in the U.S. Floodplains, https://furmancenter.org/files/Floodplain_PopulationBrief_12DEC2017.pdf

⁵ Understanding the Linkages between Climate Change and Inequality in the United States, p2.

⁶ *Id.*

Of particular concern are risk mitigation measures that force individual households and small businesses to internalize climate-related risks. Such measures may significantly restrict access to credit within already-disadvantaged communities, further reducing their capacity to respond to climate-related challenges such as weather-related disasters or sea level rise. Such measures may also expose lenders to fair lending risk under the disparate impact standard if a less-discriminatory alternative exists. For this reason, NRDC recommends that banks avoid adopting policies that seek to mitigate climate risk by restricting access to credit for individual low-income and minority households and small businesses.

To ensure compliance with fair lending obligations and promote fair access to financial services, NRDC recommends that FDIC's guidance document incorporate the following principles:

- *Banks should carefully and holistically assess their climate risk management policies and practices for potential disparate treatment or impact on the basis of race or other protected classes.*
- *Banks should collect sufficient data on lending in climate-burdened communities to understand whether their lending practices result in discriminatory treatment or impact. The data should be disclosed to FDIC and closely monitored on an ongoing basis for fair lending risk. In addition, banks should ensure that all data and models relied upon to assess climate-related risk do not include built-in biases.*
- *Banks should provide fair lending training to all staff involved in assessing climate risk for lending purposes.*

The guidance should make clear that FDIC will closely scrutinize banks' climate risk management practices in accordance with the above principles.

In addition, NRDC strongly encourages FDIC to consider additional regulatory actions to ensure fair access to financial services within climate-burdened communities, such as updating official supervisory materials to include climate-related fair lending guidance, such as the Consumer Compliance Examination Manual; encouraging banks to meet Community Reinvestment Act requirements through investment in climate adaptation measures in at-risk communities; and/or issuing further guidance or regulation on fair lending and climate. FDIC should also coordinate closely with FSOC and other relevant federal agencies (such as FEMA and HUD) to ensure that regulatory changes in the financial sector do not inhibit whole-of-government efforts to ensure an equitable climate transition.

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?

We recommend that the FDIC ask banks to obtain a complete picture of climate risk for significant borrowers and counterparties. The data providing such a complete picture has three key components: Scope 1, 2, and 3 greenhouse gas emissions, geolocation information for significant infrastructure, and any climate or sustainability disclosures made by the borrower or counterparty.

Scope 1, 2, and 3 greenhouse gas emissions tell banks about a borrower or counterparty's contribution to climate change and their vulnerability to transition risk in an orderly or disorderly move to a low emissions economy. "Scope 1 emissions are direct [greenhouse gas] emissions that occur from sources that are controlled or owned by an organization. . . . Scope 2 emissions are indirect [greenhouse gas] emissions associated with the purchase of electricity, steam, heat, or cooling." Scope 3 emissions are everything else: "the result of activities from assets not owned or controlled by the reporting organization, but that the organization indirectly impacts in its value chain. . . . Scope 3 emissions, also referred to as value chain emissions, often represent the majority of an organization's total GHG emissions."⁷ The volume and trend of greenhouse gas emissions informs a bank's picture of how a borrower or counterparty is managing transition risk.

To gauge physical risk, banks should also obtain geolocational information for key infrastructure from borrowers. This would certainly include any collateralized infrastructure, but also information on any infrastructure that underpins significant operations. If, for example, a borrower has significant property on a coastline vulnerable to tidal flooding and extreme weather, that information ought to inform a bank's risk analysis.

Finally, banks should obtain borrower or counterparty disclosures under any climate or sustainability disclosure framework. Some of this information would be duplicative of the greenhouse gas emissions and physical risk inventory discussed above, but disclosure frameworks also call for information about board oversight of climate risks, internal processes for identifying and managing climate risk, and projected financial impacts of climate risk.

⁷ EPA.gov, "GHG Inventory Development Process and Guidance," <https://www.epa.gov/climateleadership/ghg-inventory-development-process-and-guidance>.

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

In addition to the scenario analysis guidance discussed below, we recommend that the FDIC have banks report on their financed emissions, which is the volume of greenhouse gas emissions attributable to the bank’s lending portfolio. The Partnership for Carbon Accounting Financials has developed guidance to assist financial institutions with calculating their financed emissions, including guidance about how to estimate the percentage of emissions from an activity attributable to the bank’s financing.⁸ As with knowing a borrower’s footprint of greenhouse gas emissions, a bank’s financed emissions footprint and its trajectory over time helps regulators assess the bank’s vulnerability to transition risk.

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?

We agree that scenario analysis is an important climate risk management tool, and we believe it is one that all banks should be using to evaluate their climate risk and take appropriate steps to mitigate that risk. While banks seem to agree that scenario analysis is important, a recent study suggests that fewer than 10 percent of all financial institutions are using it,⁹ and small banks are less likely to have incorporated scenario analysis into their climate risk management plans.

Obtaining reliable information about borrowers’ climate risks is a problem for all banks (indeed, obtaining reliable information about companies’ climate risk is a general problem for regulators and stakeholders). For small banks that do not lend to public companies, it is an even greater challenge. The FDIC can advance banks’ use of scenario

⁸ PCAF, “The Global GHG Accounting and Reporting Standard for the Financial Industry,” <https://carbonaccountingfinancials.com/standard#the-global-ghg-accounting-and-reporting-standard-for-the-financial-industry>.

⁹ Cadwalader, *Climate Risk Study Finds Advances in Financial Industry Mitigation Strategies; Concerns Linger on Execution* (Feb. 4, 2022).

analysis by providing supervisory guidance on its role in risk management and the appropriate scenarios for banks to use in scenario analysis.

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

We strongly support the inclusion of scenario analysis for understanding the risks banks face. Past risks from extreme weather will not be a reliable predictor of climate risk, so banks will need to use models that consider that future risk. Thus, any guidance from the FDIC on scenario analysis should emphasize the importance of using models that align with the latest climate science and that assume a range of global average temperature increases, including worst case scenarios. And to model transition risk, scenario analyses should include orderly and disorderly transitions to a low carbon economy.

We encourage the FDIC to use its supervisory guidance authority to ensure that all banks eventually use scenario analysis in their climate risk evaluations, and to eventually incorporate climate stress testing into its examinations. The FDIC's use of its supervisory authority can ensure that climate risk is consistently modeled, evaluated, and mitigated by banks of all sizes.

We thank the FDIC for its consideration of our comments. If we can be of any further assistance, please do not hesitate to contact us.

Sarah Dougherty
Roger Baneman
Alfonso Pating
Sam Whillans
Tom Zimpleman
Natural Resources Defense Council
1152 15th St. NW Suite 300
Washington, DC 20005