Your Next Exam & Tough Questions On Climate Change Risks

regulatory risk management

Summary: Regulators are actively working on climate risk guidance to assist examiners during exams. Even without that, however, financial institutions are expected to address these risks. We provide you with three steps to better prepare you: review regulatory statements, analyze various portfolio risks, and check-in with third-party vendors and partners.

Since the rainy season is still here, we wondered which US city has the most rainy days? Seattle? Portland? New Orleans? Actually, Rochester and Buffalo in NY tied for the top spot with 167 rainy days per year. However, Seattle residents may refute this!

Regardless of the various views on rainy days or climate change, good bankers know to pay attention to shifts in regulatory focus. So, while climate change risks are not yet incorporated into bank examiner supervisory manuals, the topic continues to pick up steam amongst the regulatory agencies as ongoing weather events may have the potential to impact the safety and soundness of your institution. Indeed, the NY State Department of Financial Services (NYDFS) announced in late 2020 its requirements for climate risk stress tests.

Regulatory focus is growing

Even before all this, the Financial Stability Board created a task force specifically to address climate change risks affecting the financial industry. The Task Force on Climate-related Financial Disclosures (TCFD) provides recommendations to financial institutions (FIs) on how to report the financial impact of these risks more effectively. TCFD asks FIs to evaluate climate risks through various scenarios and then provide the results voluntarily in annual filings.

The NYDFS has been especially proactive in addressing these risks. The Department's Supervisor, Linda Lacewell, has actively requested financial institutions to use climate change financial risks in their governance documents, risk management policies and procedures, and business plans. Further, the NYDFS became the first US regulator to become a member of the Network for Greening the Financial System (NGFS) in September 2019.

Started in 2017, the NGFS consists of 83 central banks and financial supervisors with the goal "*to accelerate the scaling up of green finance and develop recommendations for central banks' role for climate change.*" The Federal Reserve also became a full member of the NGFS in December 2020.

The FDIC has chimed in on the matter as well. In December 2020, Martin Gruenberg, FDIC board member, stated "*financial regulators, have a compelling obligation to engage with climate change as a financial stability threat.*"

In anticipation of what examiners may be asking on climate-based risk, we give you three steps to take to better prepare you for your next exam.

1. Review regulatory statements. In April 2019, Fed Chairman Powell referred to the 1996 guidance under the FDIC Act, as justification that it would be used for credit underwriting and asset quality to provide "*supervisors the flexibility necessary to address risks from severe weather events.*" As such, examiners could end up using this guidance as the basis for assessing risks, stress testing various scenarios, and allocating capital accordingly. With that said, it is clear that the regulators are actively engaged in this topic. So, we expect that there would be further guidance developed in the relatively near-term to assist examiners during their exams.

2. Analyze various portfolio risks. Look at your loan portfolio to see where the specific risks are.

- **Geographic.** Which geographic areas are most susceptible to floods or wildfires? Which could become more vulnerable due to future weather pattern shifts? What are the physical costs, including potential damages, replacement, etc.? What are the transitional costs for the borrower, such as higher insurance or building code adjustments/reinforcements due to changes in regulations? If the borrower experiences higher costs, could the loan become impaired?
- **Agricultural.** What about your agricultural customers? How might they be affected? Have they planned accordingly? Their supply chain may also be affected, including distribution areas, so ask about that.

It will help to have conversations with all of your borrowers on how they are preparing for the effects of strong weather patterns and potential regulatory changes.

3. Check-in with third-party vendors and partners. Not only customers, but also vendors and partners can be adversely affected due to climate change risks. If that is the case, your business could be disrupted and put at risk too. Do you have off-site back-up servers located in any high-risk areas? What about your fintech partners? If they could be at risk, how would that impact your business? Have regular conversations with any third parties and/or partners about their level of risk management relating to severe climate conditions. Their answers could affect your own risk management plan.

We know that bankers are expecting examiners to ask tough questions. But, many not be thinking of some of the climate change risk management questions that are coming. We hope that we have gotten you thinking. For additional information on regulators and climate risks, feel free to re-read, "Banking Regulators Discussing Climate Risks."

TWO APPROACHES TO STRESS TEST YOUR LOANS

Now more than ever, it is important to stress test loans of all types from multiple perspectives. Choose your approach and get expert help, as needed. Learn more about credit stress testing today.