Climate Risk Pt. 1 — A Global View

regulatory risk management ESG

Summary: Regulators in the US and abroad are taking a closer look at the climate-related risks that financial institutions face, and are preparing to enhance regulatory requirements on this front. In the first installment of this 2-part series, we'll explore how climate risk is being approached by banking regulators around the world.

As climate change has become a bigger problem over the past few decades, it has had an unfortunate impact on the ocean's coral reefs. Coral reefs are a critical part of the ecosystem, helping protect coastlines against storms and erosion, as well as providing a source of food and even medicines. The Great Barrier Reef — the world's largest coral reef — has lost half of its coral over the past 30Ys. Members of the Coral Nurture Program are working to regenerate lost coral by replanting coral and building underwater structures, known as coral nurseries, that can be used to grow new coral from fragments of existing pieces.

As the financial industry grapples with its own exposure to climate change and the risk of concentrated exposures within financial institutions' lending portfolios, regulators around the world are implementing their own efforts to contain the damage by stepping up their oversight of banks' exposure to climate-related financial risk.

Global Climate Risk Regulations

The climate risks that banks face are increasing substantially, according to recent reports from the European Central Bank (ECB) and the European Systemic Risk Board (ESRB) that found heightened risk due to concentrated exposures from "high-emitting industries." As a result, the G20's Financial Stability Board and other European regulators are stepping up their oversight of banks' exposure to carbon-related concentration risk. The European Banking Authority (EBA) recently published a roadmap detailing its 3Y plan regarding environmental, social, and governance (ESG) risks among financial institutions.

Meanwhile, in the US, the OCC drafted principles in December 2021 that would require executives from banks valued at $100B or more to include assessments for climate-related financial risks in every aspect of an organization's operations. This could include board governance, risk appetite, liquidity, and even the projection of potential future losses. These organizations must also ensure that any climate-related marketing or statements are consistent with their operating strategies — essentially, eliminating greenwashing.

The FDIC followed up in March 2022 by drafting similar principles that would also require bank boards and executives to factor climate-related risk management into every part of their businesses. Meanwhile, the Biden Administration has been pushing the federal government to step up the incorporation of climate change risk into risk analysis across the board.

Guidance for Smaller Banks

Though US regulators still trail the climate-related initiatives of their European counterparts and are currently focused primarily on the banking industry's largest players, it is clear that everyone is ultimately headed in the same general direction and that regulatory changes will ultimately impact financial institutions across the board. Given this reality, community financial institutions should familiarize themselves with the changes that regulators are currently weighing, both in the US and abroad. In fact, Yue Chen, the OCC's chief climate risk officer, suggested that while smaller institutions were not currently in focus, they should still prepare now for when climate-related exams expand beyond the industry's largest players.

As your institution considers the task, you may want to thumb through the EBA's roadmap for guidance. It has a comprehensive plan for sustainable finance and outlines the following 8 objectives:

1. Heightened transparency promoted by easy access to information
2. Incorporation of ESG factors into risk management and supervision
3. Identification of areas where environmental and social risks can be better captured
4. ESG embedded into stress testing
5. Clearer labels and language that support sustainable banking products
6. Identification of features and risks of greenwashing
7. Integration of information about ESG risks into supervisory reporting
8. Monitoring of material ESG risks in sustainable finance

While regulators may not yet agree on the best way to tackle climate-related risks within the banking industry, the one thing they all seem to agree on is that they need to be addressed. With the writing on the wall, you should begin to familiarize yourself with the changes that regulators are looking at and the areas they perceive to be the biggest concerns. For greater detail on US regulator focus on climate risks, visit part two of this series.

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ECONOMY & RATES

Rates As Of: 05/25/2023 10:05AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	5.37	0.27	0.95
6M	5.42	0.36	0.66
1Y	5.21	0.47	0.50
2Y	4.47	0.47	0.05
5Y	3.87	0.38	-0.14
10Y	3.79	0.36	-0.09
30Y	3.99	0.31	0.02

FF Market	FF Disc	IORB
5.08	5.25	5.15
SOFR	**Prime**	**OBFR**
5.05	8.25	5.07