Climate Risk Pt. 2 — Climate Change Impacts on Your Risk Profile

risk management ESG

Summary: Climate change creates a carousel of risks for CFIs. In this follow-up to last week's article on global climate risk financial regulations, we discuss US regulators' plans to assess climate-based risks. We'll also provide insight on how your team can mitigate these risks by predicting, strategizing, and implementing scenarios and strategies before disaster hits.

In 2017, wildfires devastated the Northern California landscape. More than 5.7K structures were destroyed, and many homeowners found themselves unable to make their mortgage payments due to the disruption caused by the fires and the subsequent displacement.

As climate change is making natural disasters, such as wildfires, hurricanes, flooding, ice storms, and tornadoes, more frequent and intense, this scenario may become more common. At first glance, banks may not appear to be at the forefront of these evolving risks.

However, for community financial institutions (CFIs) that provide loans and facilitate business operations for customers who are often impacted by these weather events, an institution's financial and operational risks will evolve with climate change in the geographical areas they serve.

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Breaking Down the Risks

As the global climate continues to shift, banks may encounter multiple types of risks, including:

- **Regulatory risks.** You'll need to comply with existing laws and regulations related to climate change, and any changes to those regulations on the federal or state level could lead to increased compliance costs or other financial impacts.
- **Operational risks.** As in the case of any risks that could hinder operations, your risk management team will need a plan to address sudden changes in the availability of resources, technology, and services due to extreme weather. For example, a large power and telecommunications outage can disrupt electronic payments to and from your institution.
- **Reputational risks.** Your institution must manage its reputation in the event of customer and shareholder concerns related to any involvement in financing activities that exacerbate climate change. The opposite is also a risk, as some states plan to no longer do business with any bank or financial institution that divests from fossil fuels.
- **Financial risks.** Increased losses due to extreme weather events, such as floods and hurricanes, can result in a sharp rise in loan defaults or reduced property values. In FEMA-designated counties affected by Hurricane Harvey, 90+ day delinquency rates rose significantly when compared to the rates from six months earlier. Properties assessed as having damage experienced a 205% increase in delinquency, while

those not determined to be damaged saw a 167% jump in delinquency. Higher delinquency risks may also be present in Florida, which has seen a mass exodus of home insurance providers, leaving residents without insurance coverage in a state that is particularly vulnerable to hurricanes.

A Federal and Proactive Approach

In 2021, the People's Bank of China and the Bank of England began evaluating banks through climate scenario analyses, followed by the European Central Bank and Bank of Japan in 2022. The central banking system of the US is following suit and is actually the last of the major central banks to initiate this type of evaluation. The Federal Reserve announced that it will commence its first climate scenario analysis of US banks in early 2023. The Climate Scenario Analysis (CSA) program is intended to identify long-term financial risks associated with climate change.

Six scenarios will be used to assess the physical and transitional risk tolerance of six major banks: three of which involve severe hurricanes hitting the northeastern US in 2050 and three of which involve shocks for their real estate portfolios in a region of their choice. These scenarios are designed to help regulators and large financial providers anticipate the impact of climate change on their risk profiles, according to projections of what extreme climate scenarios could exist decades in the future. The exercise is expected to be completed by the end of 2023, with the results to be published in 2024.

In late April, the National Credit Union Administration Board (NCUA) approved a request for information on climate-related financial risk as well. The regulator is seeking comments and feedback from stakeholders to help them identify what tools would be most helpful to credit unions in mitigating climate risk.

How You Can Start Preparing for Climate-Risk Regulations

You can begin to implement changes to address climate change risks by considering the following:

- Develop a comprehensive climate change risk management framework that includes risk assessment, response planning, and monitoring.
- Incorporate environmental, social, and governance (ESG) criteria into current risk management strategies.
- Collaborate with other financial institutions to share resources and best practices in climate risk management.

Mitigating climate change risks is essential for CFIs to protect their investments and remain competitive in the global economy. Climate change-induced events can lead to significant losses in the form of bad debt, decreased property values, and reduced access to capital.

By taking a proactive approach to managing climate change risks, you can become better prepared to handle the potential impacts of climate change and ensure that your operations remain sustainable and profitable in an ever-changing environment.

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ECONOMY & RATES

Rates As Of: 05/30/2023 06:43AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	5.34	0.24	0.92
6M	5.44	0.38	0.68
1Y	5.22	0.49	0.52
2Y	4.55	0.55	0.13
5Y	3.89	0.40	-0.12
10Y	3.75	0.32	-0.13
30Y	3.94	0.26	-0.03

FF Market	FF Disc	IORB
5.08	5.25	5.15
SOFR	**Prime**	**OBFR**
5.06	8.25	5.07