Banking Regulators Discussing Climate Risks

regulatory

Summary: Banking regulators are discussing the effects of weather and climate. We cover the areas of physical risks and financial shocks.

The barometer was first invented in the 1600s in Italy. We have come a long way with our weather tools since then, which is a good thing since our weather events seem to need them these days.

Banking regulators are taking note too with a more focused look on the effects of weather and climate. The Federal Reserve's latest Financial Stability Report includes climate risk for the first time, noting "*Federal Reserve supervisors expect banks to have systems in place that appropriately identify, measure, control, and monitor all of their material risks, which for many banks are likely to extend to climate risks*." Also, the New York Department of Financial Services (NYDFS) banking regulator issued a letter to its member institutions outlining broad expectations on how to approach financial risk pertaining to climate-related events. This guidance follows a report from the U.S. Commodity Futures Trading Commission (CFTC) and articles from the SF Fed.

Since regulators are sprinkling climate change and the risks to community financial institutions (CFIs) into their pronouncements, we thought we would share a couple of key topics being discussed relative to climate shifts. This is still an evolving discussion, but it is an important one as regulatory expectations shift.

Physical risks. As stated by the NYDFS, these are potential damages to assets triggered by an "*increase in frequency and severity of weather events or long-term shifts in climate patterns*." The National Center for Environmental Information shows 279 weather events since 1980 costing more than $1B (CPI-adjusted), hitting a total of $1.825T.

At the local level, identifying at-risk areas could prove crucial to improving the resiliency of property and business owners. For example, Blackrock estimated 80% of commercial properties affected by Hurricanes Harvey and Irma were not included in FEMA's flood zone maps, which may have contributed to a higher number of under-insured assets. FEMA calculates 8.7MM properties are exposed to substantial risk. However, a 2020 study by First Street Foundation estimates as many as 14.6MM have similar risk levels. Having a complete picture of these risks may also be more important for CFIs than national banks, due to the geographical concentration of their loans.

Financial shocks. In the Fed's Financial Stability Report, it notes that climate change "*is likely to increase financial shocks.*" With ongoing weather disruptions accompanied by the rapid shift in perceived risk, sudden repricing events are likely to result. These climate disruptions and subsequent repricing "*can result in an increased frequency and severity of financial shocks.*" Real estate assets are especially vulnerable, as values could decrease rapidly if investors suddenly decide the risks are too high, based on information regarding an area's climate exposures. A chain reaction could then continue on to mortgage-backed securities, financial institutions, insurance companies, etc. Staying educated on all these progressing risks won't be easy, but it will help to protect your institution in the long run.

This risk discussion will likely continue on. As it does, we'll share our insights with you to keep you up-to-date.

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