THREE KEY TAKEAWAYS FROM FSOC'S CLIMATE-RELATED FINANCIAL RISK REPORT

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By: Daniel F. C. Crowley, Karishma Shah Page, Daniel S. Nuñez Cohen

INTRODUCTION

In her keynote remarks at COP26 during the Finance Day Opening Event, Treasury Secretary Janet Yellen discussed the Financial Stability Council's (FSOC) historic Report on Climate-related Financial Risk (Report). She told the world that the more than 30 "recommendations [in the Report] represent a significant and vital step towards making the U.S. financial system more resilient to the threat of climate change. We're working with our partners at the Financial Stability Board and elsewhere to support similar efforts on a global scale."

The Report provides a clear, but in-development, roadmap for federal climate-related risk policy. Understanding the Report's progress and gaps will be critical to understanding the Biden administration and the federal financial regulators' approach to climate-related financial risk regulation. We highlight three key takeaways and some near term next steps to which stakeholders should pay attention.

FSOC'S CLIMATE-RELATED FINANCIAL RISK REPORT

As Chair of FSOC, Treasury Secretary Janet Yellen has characterized the Report as "first time" that FSOC has "recogniz[ed] that climate change is an emerging and increas[ing] threat to U.S. financial stability." In her written remarks introducing the Report, Secretary Yellen specifically highlighted four recommendations:

- Assessing climate-related financial risks to financial stability, including through scenario analysis, and evaluating whether revised or new regulations or guidance is necessary to properly account for these risks;
- Promoting enhanced climate-related risk disclosures, including standardizing data formats to facilitate comparability;
- Enhancing the availability of climate-related data to allow better risk measurement by regulators and the private sector; and
- Building capacity within FSOC and its constituent members, including by establishing a staff-level Climate-related Financial Risk Committee and a Climate-related Financial Risk Advisory Committee within FSOC.

Per the Report, FSOC will also work more closely with non-U.S. regulators and coordinating bodies, including the Financial Stability Board, the Basel Committee on Banking Supervision, the International Organization of Securities Commissioners, and the Network of Central Banks and Supervisors for Greening the Financial System.

THREE KEY TAKEAWAYS FROM THE REPORT

There are numerous takeaways from the Report and Secretary Yellen's comments that stakeholders should consider. We highlight three here.

The Report is Consistent with the Current SEC and FRB Leaders' Policy Preferences

The Report emphasizes the importance of two key policies that Securities and Exchange Commission (SEC) Chairman Gary Gensler and Federal Reserve Board (FRB) Chairman Jay Powell (as well as FRB Governor Lael Brainard) have promoted:

- climate-related risk disclosures by regulated financial entities; and
- climate scenario analysis.

The Report asserts that “through [climate-related financial risk disclosure policies and climate scenario analysis] financial regulators can both promote the resilience of the financial system and help it support an orderly, economy-wide transition toward the goal of net-zero emissions.” With respect to climate-related financial risk disclosures, the Report states that FSOC is “encouraged” by the SEC's current plans to develop climate-related financial risk disclosures for asset managers and public issuers, and reiterates Governor Brainard's belief in the need for better disclosures by banks.

Regarding climate scenario analysis, the Report states that FSOC members should “use scenario analysis, where appropriate, as a tool for assessing climate-related financial risks, taking into account their supervisory and regulatory mandates and the size, complexity, and activities of regulated entities.” Consistent with public remarks by Chairman Powell and Governor Brainard, the Report recognizes that climate scenario analysis is “a building block” and will require the banking regulators to build out their data and expertise. In particular, the Report supports the use of climate scenario analysis based on work by the Network of Central Banks and Supervisors for Greening the Financial System and work at the Financial Stability Board. The Federal Reserve has been involved in these discussions and has been moving forward with these models in mind.

FSOC Encourages Members to “Incorporate Climate-related Financial Risks into Their Regulatory and Supervisory Programs” but Provides Minimal Details or Gloss

As expected, the Report encourages FSOC members to integrate climate-related financial risks into their regulatory and supervisory programs. However, the Report does not provide meaningful details or concrete recommendations beyond disclosure and scenario analysis. For instance, the Report states that members “should review regulated entities' efforts to address climate-related risks and clarify or enhance risk management requirements for regulated entities where necessary to promote appropriate consideration of climate-related financial risks.” Similarly, it states that members “should evaluate whether additional regulations or guidance specific to climate-related risks is necessary to clarify expectations for regulated or supervised institutions regarding management of climate risks.”

Neither of these recommendations provides concrete suggestions on how examination manuals, compliance aids, or legal advisory opinions or guidance should be updated to reflect climate-related financial risks. Nor are there any specific recommendations about new or revised rulemakings that should be undertaken. Notably, however, the Report explicitly recognizes concerns about “right-sizing” regulation: members “should evaluate whether additional regulations or guidance specific to climate-related risks is necessary to clarify expectations for regulated or supervised institutions regarding management of climate risks, *taking into account an institution's size, complexity, risk profile, and existing enterprise risk management processes”* (emphasis added).

An Overarching Theme is Protecting the Most Vulnerable Populations

Consistent with the Biden administration's focus on socio-economic justice programs, the Report “recommends that [FSOC's] members, consistent with their mandates and authorities, evaluate climate-related impacts and the impacts of proposed policy solutions on financially vulnerable populations when assessing the impact of climate change on the economy and the financial system.” Consistent with this view, Chairman Powell has stated that the Federal Reserve will take a more holistic view of the labor market when determining the true level of full employment. This approach will include a focus on persistently higher unemployment among Black and Latinx workers. However, he has also cautioned lawmakers in the past that the Federal Reserve does not have the tools to empower specific communities in the labor or credit markets.

EXPECTED NEXT STEPS

Most of the recommendations will take time to implement and are at preliminary stages. However, some of the recommendations are well in development. Accordingly, we expect at least a few of the recommendations to be implemented in the near term. Among others, we anticipate the following:

- The SEC will issue a notice of proposed rulemaking on mandatory climate-related financial risk disclosures for public companies by the end of the year. This rulemaking has been a top priority of Chairman Gensler as well as Commissioner Lee, and has been listed on the SEC's rulemaking agenda for months. Among other things, it is likely to include disclosures around Scope 1 and 2 (potentially even Scope 3) emissions. Congress is paying particularly close attention to the developments as are market stakeholders. The SEC is likely to receive thousands of comments;

- The Federal Reserve will unveil climate scenario analysis guidance soon, but not necessarily by the end of the year. In early October, Governor Brainard delivered a speech arguing that it would “helpful to move ahead with the first generation of climate scenario analysis to identify risks and potential issues and to inform subsequent refinements to our models and data” and noting that it would be “helpful [for the Federal Reserve] to provide supervisory guidance for large banking institutions in their efforts to appropriately measure, monitor, and manage material climate-related risks, following the lead of a number of other countries.” The Federal Reserve also issued a statement of support for the Network for the Greening of the Financial System's Glasgow Declaration; the declaration, among other things, calls for “enhance[ing] and enrich[ing] its climate scenarios.”' And

- The Comptroller of the Currency will issue climate-related financial risk guidance. Earlier this month, Acting Comptroller Hsu announced that the OCC intends to “issue framework [climate-related financial risk] guidance by the end of” 2021 and “more detailed guidance for each risk area” sometime in 2022. Among other things, Acting Comptroller Hsu has raised questions about national banks' preparedness for physical and transition risk mitigation; vulnerability to carbon taxation; and operational risk, including to critical service providers, from climate change.

CONCLUSION

The Biden administration and federal regulators will continue to focus on policy solutions to climate-related financial risk, but much of the proposals have yet to be fully developed or implemented. Of the more advanced proposals, we believe the initial contours of these rules and guidance documents are likely to change, at least somewhat, before being implemented.

K&L Gates' Public Policy and Law professionals are ready to assist stakeholders as they engage in this critical policy dialogue.

KEY CONTACTS

DANIEL F. C. CROWLEY
PARTNER

WASHINGTON DC
+1.202.778.9447
DAN.CROWLEY@KLGATES.COM

KARISHMA SHAH PAGE
PARTNER

WASHINGTON DC
+1.202.778.9128
KARISHMA.PAGE@KLGATES.COM

