



Expectations for the Treasury's Climate-Related Financial Risk Report

October 2021

President Biden's May 20th Executive Order on Climate-Related Financial Risk recognizes the climate crisis as a threat to the United States' financial system and economy. To address this threat, the Order encourages Treasury Secretary Yellen—in her capacity as Chair of the Financial Stability Oversight Council—to issue a report that considers how “climate-related financial risk can be mitigated, including through new or revised regulatory standards as appropriate.” The EO makes clear that it is “the policy of [the] Administration to . . . act to mitigate [climate] risk and its drivers” across a range of areas, including financial regulation.

The Biden Administration has taken important first steps to implement this policy. It has selected a number of climate champions for key financial regulatory posts. These appointments have had immediate effects, with the SEC asking the public for information on enhanced climate-related disclosures and stating its intent to issue a proposed rule. Meanwhile, the Treasury, which is primarily responsible for charting a course for addressing the effects of the climate crisis on the economy, has developed its first-ever climate hub, issued guidance cautioning Multilateral Development Banks against financing for most fossil fuel projects, and established a climate risk working group for the FSOC. These developments have set the stage for action.

The Treasury report under the EO must mark a clear transition into the next phase of the Administration's response to the urgent threats of the climate crisis: one that moves beyond data gathering and capacity building to call for concrete, timely, and bold action on all fronts by all FSOC members to protect the economy. It would be a grave mistake to weaken the report's recommendations to secure support from every FSOC member; it would be far better to issue a strong report with clear expectations, concrete milestones, and explicit timelines for each member agency.

The Treasury climate report must:

- Highlight the severity and urgency of the climate crisis and its grave implications for financial stability and sustainable economic growth.
- Make clear that fossil fuel finance is a primary driver of systemic climate risk, and that regulatory interventions to mitigate climate risk must address it head on. Recognize the misalignment between our climate reality and the inadequate and often counterproductive response of the finance sector. Climate science has made it clear that the added emissions from new oil and gas exploration and development are incompatible with the 1.5°C pathway needed to avoid the most catastrophic climate impacts. Despite this, U.S. banks continue to lead the world in financing new fossil fuel development, while insurers and markets misprice physical risk.
- Urge regulators to adopt a precautionary approach to systemic climate risk that allows for adequate intervention before the risk overflows. We cannot afford the hands-off approach to regulation taken in the lead up to the 2007-08 financial crisis.

- Recognize that the dangers of the climate crisis must be mitigated now, even if they may not manifest until after the usual time horizon that regulators focus on, and suggest how regulators should approach analyzing and demonstrating the need to act on those risks.
- Treat climate-related financial risk and racial and environmental injustice as correlated and inseparable risks. Marginalized communities are acutely vulnerable to climate harms and have inadequate material resources for mitigation and resilience principally because of historic and in many cases ongoing environmental racism and discrimination in land use, housing policy, financial services, and access to income and wealth..

The climate crisis poses threats to the financial system that are deeper and broader than the threat from the 2008 subprime mortgage crisis. Treasury’s report must reflect a recognition of this existential threat. It can do so by recommending the specific policies below, identifying those that regulators must immediately implement to curb the threat, and endorsing consideration of the full range of options for mitigating climate risk.

Immediate Actions the Regulators Must Take to Address Climate Risk

The financial regulators have tools they can use to address immediate risks and to develop additional expertise and information on climate risk. The Treasury report must recommend individual regulators take these steps immediately. In fact, given the urgency of the threat, the agencies should not wait for the report’s release to begin taking these steps, but rather put the wheels in motion now, as the SEC is doing with climate-related disclosure.

Banking and Prudential Regulation

- The Federal Reserve Board, OCC, FDIC, and NCUA (“banking regulators”) should issue new public supervisory guidance directing examiners to consider climate-related risks as they oversee bank safety and soundness. This guidance should include consideration of how climate change may create risks within the categories that regulators regularly assess.
- The banking regulators and FHFA should incorporate climate risk into their periodic stress tests, which assess how banks and GSEs will fare under crisis conditions. Regulators should use longer-term scenario analysis exercises to complement stress tests. The CFTC should also incorporate climate risk into supervisory stress tests.
- The banking regulators should incorporate climate risk into the reports (“call reports”) that banks file with regulators on their financial condition.

Capital Markets

- The SEC should propose, finalize, and enforce a mandatory, science-based climate disclosure framework for financial and nonfinancial institutions, including large private companies and funds, and update audit and enforcement standards for climate risk, ESG claims, and material omissions in disclosures.

- The SEC, with the cooperation of the banking regulators, should revise its Industry Guides for bank holding companies and the major industries that they invest in or rely on (oil and gas, real estate, property-casualty insurance underwriting).
- The SEC should work with PCAOB to develop expectations for disclosure assurability and completeness as well as reviews of critical audit matters related to climate change.
- The SEC should develop standardized definitions, criteria, and disclosures for ESG and sustainable funds and registered investment companies.
- The SEC should ensure that shareholders are reasonably able to raise ESG-related proposals and use proxy advisory firms to exercise their right to vote.

Actions That the Report Must Put on the Table

Along with immediate action on climate-related financial risk, it is critical that the report lay out the full set of options that are within FSOC regulators' authority for managing climate-related financial risk. Because the climate crisis poses threats to the financial system and economy that are literally unprecedented in severity and complexity, it would be irresponsible to dismiss any authority or approach that has the potential to mitigate climate-related financial risk or its drivers. The report should endorse considering every possible tool in advance. Our climate road map report linked below describes many such policies; some key examples are listed below.

Banking and Prudential Regulation

- The Federal Reserve could impose a climate-risk surcharge on global systemically important banks (GSIBs) to reflect additional systemic climate risks that the largest banks face and pose.
- The Federal Reserve, OCC, and FDIC could require banks to hold more capital to offset the higher risk profile of carbon-intensive assets or those exposed to heightened physical risks.
- Regulators could tighten the concentration limits for exposures to segments of the fossil fuel industry given the long-term decline and volatility in the sector.
- Regulators could limit unacceptably risky climate-related lending with portfolio limits or their authority to prohibit unsafe and unsound practices.
- The Treasury Secretary, OCC, and Federal Reserve Board could limit the ability of bank and financial holding companies to invest in or hold physical commodities and to engage in merchant banking activities, especially those tied to fossil fuels.
- The FDIC can adjust deposit insurance premiums to reflect climate risks to banks.
- Regulators could use Dodd-Frank authorities to incorporate climate risk into nonbank SIFI designation and regulation and include climate in a reinvigorated Volcker Rule.

- The CFTC could adjust capital and margin requirements to ensure firms and markets most exposed to climate risk are adequately protected.
- The Treasury Secretary could work with the Federal Reserve to establish policies governing future bailouts that ensure they protect workers and the general public, do not contribute to financial instability, ameliorate rather than exacerbate the climate crisis, and do not foster moral hazard by rewarding reckless conduct by financial institutions or the managers of other large businesses.

Capital Markets

- The SEC could require investment advisors to adopt and implement sustainable investment policies, and to disclose in prospectuses how they address ESG issues.
- The CFTC could initiate rulemaking to set speculation limits that curb or stop market participants from speculating in climate-related derivatives if they might create further systemic risk.
- The SEC could issue a rule requiring credit rating firms to adopt, integrate, and publish policies on how they consider climate-related risks in their credit ratings, and could deny a credit rating agency's registration to rate new classes of non-credit securities if it determines that the agency has ever issued ESG ratings that were arbitrary or misleading, or lacked a comprehensive methodology.

References

- [Climate Roadmap for U.S. Financial Regulation](#)
- [Recommendations for Supervisory Guidance from Bank Regulators](#)
- [Letter in Response to the SEC's Climate Disclosure RFI](#)
- [Letter in Response to the FHFA's RFI on Climate and Natural Risk Management](#)
- [Green Central Banking Scorecard](#) and [How Green is the Fed?](#) Supplement
- [Public Citizen comment](#) on the New York Department of Financial Services' Climate Guidance for Insurers
- [Letter to President Biden on Addressing Climate Risk at the Federal Reserve](#)