Jerome H. Powell
Chair
Board of Governors of the Federal Reserve System
20th St. and Constitution Ave.
Washington, DC 20551

Re: Docket No. OP-1793, "Principles for Climate-Related Financial Risk Management for Large Financial Institutions"

To Chair Powell and the Board of Governors of the Federal Reserve System:

I am writing in response to the notice and request for comment on "Principles for Climate-Related Financial Risk Management for Large Financial Institutions" put forth by the Board of Governors of the Federal Reserve System (the Board). This proposal outlines a framework and set of principles for assessing and managing climate-related risks for U.S. banks and financial institutions with over $100 billion in total consolidated assets. I have serious reservations about the costs and benefits of the proposed principles as well as their distributional consequences.

I am a senior research faculty member at the American Institute for Economic Research (AIER). AIER is a nonpartisan research institute that does not endorse particular legislation or political candidates. The views discussed here are my own and are not necessarily those of AIER. They are merely comments on the high-level framework and principles proposed by the Board. They should not be considered endorsement of, nor advice on, any specific policy.

Despite the document's label as a set of "principles," the proposal includes a number of policies the Board would require for large U.S. banks and financial institutions. The policies themselves are mostly vague and not clearly defined. The costs and benefits of these policies are uncertain and are not well articulated in the proposal. Given the uncertainty of their effects, it seems likely that the harms from many of these policies will exceed their benefits. In this letter, I provide six points that the Board should consider and respond to before finalizing any climate-related policies.

1. The proposal does not clearly explain how banks will be affected by climate-related risks.

The proposal lists a number of events that might potentially affect banks' net incomes and asset values. These include physical risks, described as arising from "acute, climate-related events, such as hurricanes, wildfires, floods, and heatwaves, and chronic shifts in climate, including higher average temperatures, changes in precipitation patterns, sea level rise, and ocean acidification," as well as transitional risks from changes in policy, technology, and consumer or business sentiment.

The proposal does not explain, however, exactly how banks — and more importantly the banking system — might be affected by such events. In what way, for example, does ocean acidification pose a systemic financial risk to the U.S. banking system?

Furthermore, how do such risks differ from non-climate-related risks? Banks already have insurance for events such as floods, wildfires, hurricanes, and natural disasters. Does the Board believe that its current risk-management rules in these areas are insufficient? If so, why not revise those requirements, rather than initiating a new and much more intrusive regulatory framework explicitly dedicated to climate?

Bank regulation typically focuses on adverse events that threaten a bank's solvency or liquidity, particularly if such harms might affect other banks or pose risks to liquidity of the entire banking system. Insolvency and illiquidity stem from unpredictable events. Climate risks, in contrast, are well-known, long-run risks as evidenced by the proposal's repeated references to long-term horizons beyond the banks' typical strategic planning period.

In fact, the language of the proposal indicates that the Board is not even sure if climate events will have any effect at all on bank liquidity. As the proposal describes, "management should assess *whether* climate-related financial risks could affect its liquidity position and, *if so*, incorporate those risks into their liquidity risk management practices and liquidity buffers." If climate events are not known to affect bank liquidity, why do regulators believe they will affect financial liquidity or create risks to the banking system?

To make these principles useful, the Board must specify exactly how and under what conditions they believe each of these various risks will affect banks' solvency and liquidity. Without specific guidance from the Board as to how these risks should be assessed and mitigated, the proposal will be viewed as a political measure to stunt lending to fossil fuel companies rather than a legitimate effort to address bank risk.

2. The policies discussed in the proposal are costly, and it is not clear how they will reduce climate-related risk.

The proposal would require banks to build an extensive climate-risk analysis. These include tools such as heat maps and climate-risk dashboards. Banks could be required to conduct self-administered climate-related scenario analysis tests, monitoring developments in climate modeling methodology, and testing the correlation of climate risks across asset classes. Such requirements are likely to be accompanied by sizable burdens in paperwork, reporting, and bureaucracy.

What are the expected benefits of these new requirements? The Board has provided no evidence that these new policies will reduce the effects of climate-related risk on banks' incomes or asset values.

It is incumbent upon the Board to specify not only how banks will be affected by climate-related risks but also how banks' actions will abate such risks. Banks should not be required to comply with any requirements unless the Board can identify their precise benefits. If the scientific value of such tools is still uncertain, then the Board should refrain from requiring such measures until their effectiveness can be established.

3. There is no evidence provided that the benefits of these proposed policies will exceed their costs.

The proposal lacks any evidence that the new policies will effectively reduce climate-related risk, or that their benefits will exceed the costs. It is vital that any climate-related rules be established through the notice-and-comment rulemaking process. New rules should be subject to quantitative cost-benefit analyses to ensure that they will create positive net benefits for Americans, the economy, and the financial system.

The costs of regulatory requirements can be substantial. Excessive regulations stifle innovation and economic growth. Reductions in bank regulations that increase competition have been found to substantially benefit low-skilled and low-income workers.[1] Some regulations have the unintended consequence of increasing bank risk, such as rules that encouraged banks to increase their holdings of mortgage-backed securities and collateralized debt obligations prior to the 2008 financial crisis.[2] Given these negative consequences, quantitative cost-benefit analysis is vital to discerning whether any new policy is in the best interest of society.

To my knowledge, however, the Board has never conducted a quantitative cost-benefit analysis for any of its proposed rules. In a recent study, I examined 27 proposed and finalized capital and related liquidity rules. I found that in *zero* cases did the Fed provide a quantitative cost-benefit analysis indicating that the rules would provide net benefits for society.[3]

The Board should commit to conducting quantitative cost-benefit analyses of any proposed climate-risk-related rules through the standard notice-and-comment rulemaking process.

4. The proposal is not limited to financial risk but suggests extensive changes in banks' operations and business activities.

Chair Powell has said that the Federal Reserve (the Fed) has "narrow, but important, responsibilities regarding climate-related financial risks."[4] The proposal, however, goes far beyond limiting financial risk by suggesting changes to banks' operations, strategies, and business activities.

The proposal discusses whether businesses should evaluate climate risks "beyond the institution's typical strategic planning horizon" and consider changes to "the financial institution's overall business strategy" as well as "changes to its compensation policies." These instructive policies go well beyond the Board's appropriate role in helping banks manage

[1] Thorsten Beck, Ross Levine, and Alexey Levkov (2010) "Big Bad Banks? The Winners and Losers from Bank Deregulation in the United States," Journal of Finance 65: 1637–67.
[2] Stephen Matteo Miller (2018) "The recourse rule, regulatory arbitrage, and the financial crisis," Journal of Regulatory Economics 54: 195–217.
[3] Thomas L. Hogan (2019) "A Review of the Regulatory Impact Analysis of Risk-Based Capital and Related Liquidity Rules," Journal of Risk and Financial Management 14(1), 24.
[4] Jerome H. Powell (2023) Panel on "Central Bank Independence and the Mandate—Evolving Views" At the Symposium on Central Bank Independence, Sveriges Riksbank, Stockholm, Sweden. January 10, 2023. Available online https://www.federalreserve.gov/newsevents/speech/powell20230110a.htm

financial risk. Aside from addressing specific climate-related risks (which, as previously discussed, the Board has failed to adequately identify), the Board has no cause to direct banks' operations, strategy, or business activities.

In addition, conformity in risk policies is likely to increase systemic risk in the banking system. Requiring conformity in business practices and risk management would make all large banks subject to the same types of risk. By reducing diversity in risk management and business practices, standardized climate-risk policies can inadvertently create systemic risk.

5. The proposed policies will have distributional effects on companies, industries, and socioeconomic groups.

Chair Powell has promised that the Fed's climate policies would not have distributional effects on particular businesses or industries. He said that "it would be inappropriate for [the Fed] to use our monetary policy or supervisory tools to promote a greener economy or to achieve other climate-based goals."[5]

Despite these comments, the Board's proposed policies will undoubtedly affect particular companies and industries by pressuring banks to lend to low-carbon or "green" energy projects, and not lend to companies in the traditional fossil fuel industry. In fact, the Fed has explicitly committed to pursuing a non-neutral policy by joining the Network for Greening the Financial System, an organization of central banks whose stated purpose is "to mobilize capital for green and low-carbon investments in the broader context of environmentally sustainable development."[6]

It is also likely that the Board's proposal will affect the geographic distribution of bank lending through the use of heat mapping and geographic analysis. Geographic restrictions on lending are reminiscent of the redlining practices adopted by the Home Owner's Loan Corporation which directed banks to restrict lending in low-income communities and are known to have disproportionately reduced credit to minority borrowers.[7]

The confusion over distributional effects is evident in the proposal itself. The proposal warns that climate change could have "potentially disproportionate impact on the financially vulnerable, including low- to moderate-income (LMI) and other disadvantaged households and communities." Should banks minimize these disproportionate risks by restricting lending by income or geography? Are there other ways to hedge such risks without distributional consequences? The proposal does not say.

To resolve this discrepancy, the Board should re-emphasize that climate-related policies should have no distributional effects with regard to companies, industries, or socioeconomic groups.

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[5] Ibid.

[6] Network for Greening the Financial System, "Origin and Purpose." Available online at https://www.ngfs.net/en/about-us/governance/origin-and-purpose

[7] ouis Lee Woods, II (2012) "The Federal Home Loan Bank Board, Redlining, and the National Proliferation of Racial Lending Discrimination, 1921–1950," Journal of Urban History 38: 1036–59.

6. The Board should focus on the risks themselves, not their relation to the climate.

If the Board is truly concerned with financial risk rather than on climate policy, then its policies should reflect this by directing its attention to the actual risks to banks and the banking system, rather than on the origins of such risk, be it climate or otherwise.

Rather than the policies and principles laid out in Docket No. OP-1793, the Board should adopt a general principle that emphasizes actual risk exposure. As an example:

> Regulations shall treat climate-related risks no differently than non-climate-related risks such as flooding, weather events, or natural disasters.

Again, this wording should not be considered a specific policy proposal but simply an example of how a good policy might be formulated.

I hope the Board will find these comments useful in revising its principles of climate-risk management and in the formation of any climate-related policies.

Sincerely,

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