VIA EMAIL
Board of Governors
Federal Reserve System
20th Street and Constitution Avenue NW
Washington, D.C. 20551

Attention:
Ann E. Misback
Secretary

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

Dear Governors:

On behalf of the Natural Resources Defense Council (NRDC), we are pleased to submit these comments on the draft Principles for Climate-Related Financial Risk Management for Large Financial Institutions (the "*Principles*") issued by the Federal Reserve System. NRDC is an international nonprofit environmental organization with more than 3 million members and online activists. Since 1970, our lawyers, scientists, and other environmental specialists have worked to protect the world's natural resources, public health, and environment. NRDC has offices in New York City, Washington D.C., Los Angeles, San Francisco, Chicago, Montana, and Beijing. Through its finance and legal experts, NRDC remains engaged in financial regulation and views sensible financial regulation as an integral part of mitigating climate change.

We appreciate the Board's leadership on this important first step to integrate climate-related financial risk into its prudential supervision of large banks. Climate change presents a serious threat to individual banks and to the financial system. Banks should be encouraged to identify and mitigate climate-related financial risk and guidance from the Federal Reserve will ensure that banks will rigorously undertake these efforts.

The Introduction section of the *Principles* cogently describes the emerging threat to individual financial institutions and to the financial system posed by climate change, both from physical risk and from transition risk. We therefore proceed directly to addressing the questions posed by the RFI.

The Board specifically asks for comments, including on the following questions.

Question 1: In what ways, if any, could the draft principles be revised to better address challenges a financial institution may face in managing climate-related financial risks?

Question 2: Are there areas where the draft principles should be more or less specific given the current data availability and understanding of climate-related financial risks? What other aspects of climate-related financial risk management, if any, should the Board consider?

Question 3: What challenges, if any, could financial institutions face in incorporating these draft principles into their risk management frameworks?

The *Principles* are directed at financial institutions with over $100 billion in total consolidated assets. Ultimately, as the Fed appears to recognize, guidance must be developed to apply to virtually all institutions; the Fed supervises and examines about 5,000 banks and savings associations. However, the requirements will presumably be tailored to take into account the institution's size as well as other considerations. For questions 1 and 3, we focus our comments on how the Fed's guidance might be fashioned for smaller institutions, including community banks.

We understand why the Fed might choose, as a first step, to address the guidance only to the largest institutions. These larger institutions have more internal resources to develop the robust governance and operational procedures necessary to address climate-related financial risk, as well as purchase the data needed to fully consider the risk to their portfolios. But it is important that the Fed follow up promptly with a timeframe and then the actual issuance of guidance for smaller banks, appropriately tailored to their situations. The *Principles* put smaller banks on notice that climate risk guidance applicable to them will be forthcoming. A more specific timeframe for complying with such guidance will assist smaller banks in beginning internal preparations for compliance and the actual issuance of tailored guidance will allow them to complete their preparations. It is not too soon to start thinking about the guidance that would apply to smaller institutions. There are two factors that stand out when considering how to craft guidance for the smaller institutions.

First, their risk profile will generally be very different from that of larger institutions. They may have far greater concentration risk, including industry and geographic concentrations. For example, a large percentage of their loan portfolio might consist of loans to farmers with outsize drought risk, to coastal property owners with worsening hurricane and flooding exposure, or to fossil fuel businesses jeopardized by transition risk.

From an institutional safety and soundness perspective, it is important to identify these concentration risks. Portfolio diversification may be difficult without impairing the institution's mission of serving the local community. This issue may be particularly acute for low-to-moderate income (LMI) or disadvantaged communities.

The second difference is that smaller institutions will tend to have fewer internal resources to address climate-related financial risk. They have a smaller portfolio over which to spread fixed costs such as hiring personnel to deal with climate issues.

But even within these constraints, there are ways in which smaller institutions, including mission-driven community banks, can address climate change risk. As the Board moves forward, in its climate risk regulation, from the largest institutions to smaller institutions, it should consider requiring the following strategies—strategies that could be employed by any institution, but particularly by smaller institutions:

- Collecting climate-related information from borrowers. Borrowers will be acutely aware of their recent experience with extreme weather events and their impact on their properties and businesses. This information would be relatively easy to collect and may be more locally focused than published data.
- Collecting climate-related information from databases. There are both publicly available and proprietary databases with up-to-date extreme weather information. Public databases include NOAA's Climate Data Online and the National Digital Forecast Database generated by the National Weather Service and the National Centers for Environmental Prediction. For the proprietary data, cost may be an issue for smaller banks, and the government may have to subsidize smaller banks' access to this data. In addition, the Fed has both existing data and data collection resources within its system (including the District Banks) that can be marshalled to assist smaller banks.

- Incorporating climate risk into the loan origination process. This would enable banks to consider climate risk as part of their ordinary business operations. An appropriate list of questions and considerations, tailored to the locale of the bank's borrowers, would have to be developed. The bank would also have to be sensitive to any adverse impact their process could have on LMI and disadvantaged communities.
- Employee training. It would have to be determined which employees would receive training, who would provide the training, and what information or skills would be covered.
- Using climate scenarios for stress testing. While stress testing is a valuable tool for evaluating climate risk exposure that we strongly support, it may make sense to adopt stress testing first for larger banks. We note that the Fed has very recently launched a pilot climate scenario analysis exercise to be undertaken by six of the largest bank holding companies. The Fed can use the lessons learned from this exercise and other climate stress testing measures applied to the larger banks to then craft stress testing rules appropriate for smaller banks. We urge the Fed to continue making expeditious progress with large banks after learning from your pilot climate scenarios, especially with the next largest banks beyond the initial six. And even small banks should be assessing their loss exposure from climate risk even if they do not conduct formal climate stress testing.
- Requiring resilience measures to be taken by borrowers. This could be a useful adaptation strategy that would allow smaller banks to continue to lend to their current borrower base. However, the costs would have to be financed in some fashion, which may raise difficulties for LMI and disadvantaged communities.
- Increasing capital reserve requirements for fossil fuel assets. This is a strategy that the Fed should consider, particularly as fossil fuel transition risk continues to mount.

One adaptation technique that we wish to raise a cautionary flag about is the use of insurance (or financial derivatives) by borrowers or the bank itself to shield the bank from climate risk. Casualty insurance is generally written on an annual basis. Thus, even if a borrower duly obtains casualty insurance at the outset of a loan, the premiums may increase for renewals, especially as climate-related extreme weather events worsen over time, and may potentially become unaffordable--or coverage may even be discontinued. This is particularly an issue for LMI or disadvantaged communities. In addition, insurance may be subject to counterparty risk, as insurance companies themselves are exposed to extreme weather events and fossil fuel transition risk in their own portfolios. These shortcomings are also relevant to the use of financial derivatives, such as weather derivatives. Thus, while there may be a role for insurance or derivatives as an adaptation strategy, they should be used with caution.

While the *Principles* call attention to transition risk, the Fed should ensure that their bank examiners, as they carry out their bank oversight duties, call specific attention to the risk of "stranded assets", such as oil and gas reserves that, while valuable today, are at risk of losing their value as we transition to a low carbon economy. Similarly, although we seek concerted governmental and private sector efforts to usher in a relatively smooth transition to a low carbon economy, there is also a risk, noted in the *Principles*, of a disorderly transition with dramatic declines in fossil fuel prices as the market reacts to manifestations of climate change. A disorderly transition of this nature could severely impair the value and liquidity of collateral and loan repayment prospects in the fossil fuel sector. The Fed should ensure that their bank examiners call attention to this risk of disorderly transition as well.

An important challenge that financial institutions (both large and small) face in incorporating the *Principles* into their risk management frameworks is the fair lending implications (both legal and moral) of their climate risk strategies. As outlined below, there is a real danger that the adoption of enhanced climate risk mitigation measures by banks may result in disproportionate treatment of or impact to climate-burdened communities, including lower-income communities and communities of color. We urge the Fed to consider additional regulatory actions to address likely impacts on disadvantaged communities.

Fair lending laws prohibit banks from engaging in discriminatory lending practices.[1] There are two categories of discriminatory practices for fair lending purposes. *Disparate treatment* occurs when a lender treats a borrower differently based on a proscribed characteristic, such as race or sex. *Disparate impact* occurs when a facially neutral policy or practice disproportionately burdens a protected class of persons.[2] If a disparate impact exists, the lender must show that the policy or practice is justified by "business necessity." Even if a business necessity exists, however, the lender

[1] 15 U.S.C. § 1691(a); 42 U.S.C. § 3605(a). The Equal Credit Opportunity Act proscribes discrimination on the basis of race or color, religion, national origin, sex, marital status, age, source of income, or attempted exercise of consumer rights. The Fair Housing Act proscribed discrimination on the basis of race or color, national origin, religion, sex, familial status, or handicap. Id.

[2] See Regulation B, 12 CFR Part 1002, Comment 6(a); 24 CFR 100 s 100.500.

may be liable if there are alternative policies that serve the same purpose with less discriminatory effect.[3]

Fair lending risk is especially acute where risks are distributed unevenly among potential borrowers in a manner that aligns with one or more protected characteristics, such as race. Climate change fits squarely within this category. A substantial and growing literature demonstrates that many climate-related risks, such as the risk of weather-induced disaster or sea level rise, may be disproportionately borne by lower income communities and communities of color.[4] A November 2021 Staff Report by the Federal Reserve Bank of New York surveyed this literature and concluded that "regions of the United States that are home to above-average shares of low-income and minority groups are likely to suffer the greatest meteorological effects of climate change."[5] The report also found that "low-income and minority Americans are limited in how they may adapt to climate change because they have less access to insurance and are less likely to have access to credit when needed."[6]

The close correlation between climate and race (among other factors) raises the possibility that bank policies and practices intended to mitigate climate risk may create fair lending liability through disparate treatment of or disparate impacts on borrowers of color. Moreover, even where bank practices do not give rise to legal liability under fair lending laws, they may unreasonably restrict access to financial services within climate-burdened communities.

Of particular concern are risk mitigation measures that force individual households and small businesses to internalize climate-related risks. Such measures may significantly restrict access to credit within already-disadvantaged communities, further reducing their capacity to respond to climate-related challenges such as weather-related disasters or sea level rise. Such measures may also expose lenders to

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[3] Id.; see also Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Reserve Board, Office of Thrift Supervision, and National Credit Union Administration, Interagency Fair Lending Examination Procedures (August 2009).

[4] See, e.g., Buchanan, Maya K., Scott Kulp, Lara Cushing, Rachel Morello-Frosch, Todd Nedwick, and Benjamin Strauss. "Sea Level Rise and Coastal Flooding Threaten Affordable Housing." Environmental Research Letters 15, no. 12 (2020): 124020; Keenan, Jesse, and Elizabeth Mattiuzzi. "Climate Adaptation Investment and the Community Reinvestment Act." Community Development Research Brief 05 (2019): 01-30; Furman Center, Population in the U.S. Floodplains, https://furmancenter.org/files/Floodplain_PopulationBrief_12DEC2017.pdf

[5] Understanding the Linkages between Climate Change and Inequality in the United States, p2.

[6] Id.

fair lending risk under the disparate impact standard if a less-discriminatory alternative exists. For this reason, NRDC recommends that banks avoid adopting policies that seek to mitigate climate risk by restricting access to credit for individual low-income and minority households and small businesses.

To ensure compliance with fair lending obligations and promote fair access to financial services, NRDC recommends that the Fed's guidance document incorporate the following principles:

- Banks should carefully and holistically assess their climate risk management policies and practices for potential disparate treatment or impact on the basis of race or other protected classes.
- Banks should collect sufficient data on lending in climate-burdened communities to understand whether their lending practices result in discriminatory treatment or impact. The data should be disclosed to FDIC and closely monitored on an ongoing basis for fair lending risk. In addition, banks should ensure that all data and models relied upon to assess climate-related risk do not include built-in biases.
- Banks should provide fair lending training to all staff involved in assessing climate risk for lending purposes.

The guidance should make clear that the Fed will closely scrutinize banks' climate risk management practices in accordance with the above principles.

In addition, NRDC strongly encourages the Fed to consider additional regulatory actions to ensure fair access to financial services within climate-burdened communities, such as updating official supervisory materials to include climate-related fair lending guidance, such as the Consumer Compliance Examination Manual; encouraging banks to meet Community Reinvestment Act requirements through investment in climate adaptation measures in at-risk communities; and/or issuing further guidance or regulation on fair lending and climate. The Fed should also coordinate closely with FSOC and other relevant federal agencies (such as FEMA and HUD) to ensure that regulatory changes in the financial sector do not inhibit whole-of-government efforts to ensure an equitable climate transition.

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We thank the Fed for considering our comments. If we can be of any further assistance, please do not hesitate to contact us.

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