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Statement by

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Board of Governors of the Federal Reserve System

before the

Subcommittee on Financial Institutions and Monetary Policy

of the

Committee on Financial Services

U.S. House of Representatives

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Chairman Barr, Ranking Member Foster, and members of the subcommittee, thank you for the opportunity to discuss the Federal Reserve's supervisory work related to the financial risks of climate change.

The Federal Reserve's responsibilities with respect to climate change are important, but narrow. These responsibilities are tightly linked to our responsibilities for bank supervision and financial stability. Because climate change could pose challenges for the financial system, it is important that we better understand these risks. Our primary focus is to evaluate whether banks operate in a safe and sound manner and manage all material risks, including climate-related financial risks. We are also working rigorously to identify and measure how climate change could increase financial sector vulnerabilities and amplify shocks.

My remarks today will focus on the Federal Reserve's supervisory work. Before proceeding, it is important to emphasize two general points about our approach. First, the Federal Reserve recognizes that decisions about policies to address climate change itself should be made by the elected branches of government. As Chair Powell stated earlier this year, the Federal Reserve is not a climate policymaker.[1] The Federal Reserve's supervisory responsibilities are focused on understanding and mitigating the potential impact of climate change on supervised banks.

Second, it is not and never has been the Federal Reserve's policy to discourage banks from offering accounts or services to any class or type of law-abiding business, and this is not a part of our work looking into climate-related financial risk.

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[1] Chair Jerome H. Powell, Panel on "Central Bank Independence and the Mandate—Evolving Views," speech at the Symposium on Central Bank Independence, Sveriges Riksbank, Stockholm, Sweden, January 10, 2023, https://www.federalreserve.gov/newsevents/speech/powell20230110a.htm.

Supervision Overview

Our supervisory work related to the financial risks from climate change is based on our core responsibility to ensure that banks understand and appropriately manage all material risks, including any related to climate change. Weaknesses in how banks identify, measure, monitor, and control climate-related financial risks could adversely affect a bank's safety and soundness. To fulfill this supervisory responsibility, the Federal Reserve is working to better understand the potential implications of climate change for supervised banks, engaging with large banks, pursuing independent analysis on potential risks and opportunities, discussing issues with a wide range of external experts, and monitoring industry developments.

Banks are likely to be affected by both the physical risks and transition risks associated with climate change, collectively known as climate-related financial risks. Physical risks refer to the harm to people and property arising from acute, climate-related events, such as hurricanes, wildfires, and floods, and chronic shifts in climate, including higher average temperatures, changes in precipitation patterns, and sea level rise. Transition risks refer to stresses to institutions or sectors arising from the shifts in consumer and business sentiment, technologies, or policy associated with the changes that would be part of a transition to a lower carbon economy.

These risk drivers can manifest as traditional banking risks, including as the credit, market, liquidity, operational, and legal risks that are at the core of a bank's traditional risk-management framework. While there is considerable uncertainty about the timing and magnitude of the impact of climate change across different institutions with different risk profiles, it is prudent to build capacity to better understand the range of risks. Large banks, for example, are increasingly focused on the risks and opportunities that climate change brings, and supervisors need to understand this.

The Federal Reserve has two near-term supervisory priorities related to the financial risks of climate change: issuing interagency guidance for large banks and conducting a pilot climate-scenario analysis exercise. Both of these will deepen our understanding of climate-related financial risks and support the resiliency of supervised firms.

I will briefly discuss each of these efforts.

Guidance

Last December, the Federal Reserve asked for public comment on draft guidance providing a high-level framework for the safe and sound management of exposures to climate-related financial risks for large banks.[2] The principles-based guidance would apply only to banks with over $100 billion in total consolidated assets. These proposed principles are substantially similar to the proposed principles issued by the Office of the Comptroller of the Currency (OCC) in December 2021 and the Federal Deposit Insurance Corporation (FDIC) in March 2022.

The proposed guidance contains high-level principles covering six areas: governance; policies, procedures, and limits; strategic planning; risk management; data, risk measurement, and reporting; and scenario analysis. The guidance also describes how climate-related financial risks can be addressed in specific prudential risk areas including credit, liquidity, other financial risks, operational, legal and compliance, and other nonfinancial risks.

[2] Board of Governors of the Federal Reserve System, "Federal Reserve Board Invites Public Comment on Proposed Principles Providing a High-Level Framework for the Safe and Sound Management of Exposures to Climate-Related Financial Risks for Large Banking Organizations," news release, December 2, 2022, https://www.federalreserve.gov/newsevents/pressreleases/other20221202b.htm.

The Federal Reserve received a large number of comments, and staff are carefully reviewing all of the comments received. We intend to coordinate with the OCC and FDIC in issuing any final guidance to promote consistency across supervision of large financial institutions.

Scenario Analysis

Climate scenario analysis—in which the resilience of financial institutions is reviewed under different climate scenarios—is an emerging risk-management and supervisory tool used to evaluate climate-related financial risks.

The pilot climate scenario analysis (CSA) exercise launched in January with six of the largest banks. This exercise was designed with two objectives: to learn about large banking organizations' climate risk-management practices and challenges and to enhance the ability of both large banking organizations and supervisors to identify, measure, monitor, and manage climate-related financial risks.[3] The exercise is expected to conclude by the end of the year.

The six participating banks will analyze the impact of scenarios for both physical and transition risks related to climate change on specific assets in their portfolios. We will gather qualitative and quantitative information over the course of the pilot, including details on governance and risk-management practices, measurement methodologies, risk metrics, data challenges, and lessons learned.

The Federal Reserve expects to publish insights gained from the pilot, reflecting what we learn about climate risk-management practices and how insights from scenario analysis will help

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[3] Board of Governors of the Federal Reserve System, *Pilot Climate Scenario Analysis (CSA) Exercise: Participant Instructions* (Washington: Board of Governors, January 2023), https://www.federalreserve.gov/publications/climate-scenario-analysis-exercise-instructions.htm.

identify potential risks and promote effective risk-management practices. No firm-specific information will be released.

I should emphasize that we view climate scenario analyses as distinct and separate from the Federal Reserve's supervisory stress test. The Federal Reserve's stress test is designed to assess whether large banking organizations have enough capital to continue lending to households and businesses during a severe recession and financial market shock. The pilot CSA exercise, on the other hand, is exploratory in nature and does not have consequences for bank capital or supervisory implications.

Conclusion

As I mentioned at the beginning of my testimony, the Federal Reserve's role with respect to climate change is important, but narrow. The Federal Reserve has a duty to understand risks to the safety and soundness of the banks it oversees and to the financial system, including the financial risks from climate change.

Thank you. I look forward to your questions.