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Supervisory and Regulatory Approaches to Climate-related Risks: FSB, OCC and FDIC

Even as regulatory authorities and international standard-setters work to establish consistency across climate-related risk measurement and management frameworks, financial services companies must look to their specific regulatory authorities for direction and guidance. Jurisdictional differences are expected. The FSB guidance and recommendations align with recent draft principles released from the OCC and FDIC, which signal that the financial services regulators' expectations will go beyond the SEC's proposed disclosure requirements and are likely to fall under their existing safety and soundness, resiliency, and enterprise risk management authorities. They note they intend to issue subsequent guidance that would distinguish roles and responsibilities for boards and management; this follows earlier OCC guidance on questions boards should be asking about climate change and financial risks. Going forward, financial services companies should expect the U.S. regulators to set their own course, informed by international frameworks and regulations; they will focus on climate-related governance, risk management, and scenario analysis, inclusive of higher expectations in areas like stress testing, portfolio/sector analysis, due diligence, and integration across all risk pillars.

Supervisory and regulatory approaches to climate-related risks: FSB proposal

The Financial Stability Board (FSB) issued a consultative report that is intended to assist supervisory and regulatory authorities in developing their approaches to monitoring, managing, and mitigating climate-related risks and also to promote consistent approaches across sectors and jurisdictions. It focuses on FSB states the report and related recommendations have been prepared in coordination and cooperation with the standard-setting and international bodies, including the Basel Committee on Banking Supervision (BCBS), International Association of Insurance Supervisors (IAIS), the International Organisation of Securities Commissions (IOSCO), and the Network for Greening the Financial System (NGFS), and are intended to complement work in their respective sectors.

The FSB focuses on three areas that it considers to be "cross-sectoral and system-wide aspects of climate-related risk:"

1. Reporting and collection of climate-related data as foundational to identification and monitoring of risks
2. System-wide approaches to assessing risk, including analytical tools such as scenario analysis and stress testing
3. Consideration of macroprudential policies and tools to address systemic risks

An outline of each follows.

1. Supervisory and regulatory reporting and collection of climate-related data from financial

institutions as foundational elements in the identification and monitoring of climate-related risks. The FSB identified a lack of "consistent, comparable, and granular" climate data provided by financial institutions as one of the main challenges impacting regulators' development of supervisory and regulatory approaches to climate-related risks. To address this challenge, the FSB recommends supervisory and regulatory authorities:

- Accelerate identification of their information requirements for the purpose of addressing climate-related risks and work toward identifying, defining, and collecting climate related data and key metrics to inform risk assessment and monitoring.
- Establish supervisory expectations for financial institutions' governance, processes, and controls over reporting climate-related data, including internal audit review. Consideration should also be given to the use of third-party verification to strengthen the reliability of climate-related data, such as emerging key metrics that will be utilized by other authorities and financial market participants.
- Utilize common definitions (such as those established by the standard-setting and international bodies) for physical, transition, and liability risks.
- Require financial institutions to report qualitative and quantitative data, as well as raising reporting standards and requirements as data quality improves.

The FSB concludes that "as authorities continue to evaluate their information needs and move towards regular standardized regulatory reporting requirements, key policy considerations include: the expansion of regulatory returns to gather more granular and specific climate-related data on a regular basis; capacity building, including upskilling staff and developing analytical tools; information system capabilities; and proportionality, taking into account the nature, size, and risk profile of a financial institution."

2. **System-wide supervisory and regulatory approaches to assessing climate-related risks, including the use of analytical tools such as scenario analysis and stress testing.** FSB states that supervisory and regulatory risk assessments and policies need to better incorporate understanding of the channels for how climate-related risks to financial institutions may be transferred across sectors or borders. They suggest that this "system-wide approach" to climate-related risks would draw on elements of existing prudential frameworks: (1) supervisory review and evaluation processes; (2) use of risk analytical tools such as scenario analysis and stress testing exercises; (3) supervisory actions to address deficiencies in the risk management of climate-related risks; and (4) macroprudential tools and policies to address systemic risks. While FSB acknowledges that supervisory and regulatory authorities are expanding their approaches to factor in system-wide aspects such as spillovers, risk transfers, and feedback loops, the development of policies are in the early stages.

   The FSB recommends supervisory and regulatory authorities:

   - Account for the potential widespread impact of climate-related risks across the financial system in addition to taking microprudential measures at the firm level.
   - Expand the use of climate scenario analysis and stress testing as a tool for macroprudential purposes, including in the design of each tool:
     - Physical and transition risks
     - Key financial sectors, such as banks, insurers, asset managers, and pension funds
     - Interdependencies, such as physical and transition risks, and geographical and sectoral risks
     - System-wide aspects of climate-related risks, such as indirect exposures, risk transfers, spillovers, and feedback loops.
   - Consider the range of financial risks (e.g., credit, market, liquidity) to the extent they pose material risks.
   - Make use of climate scenarios developed by the NGFS, as appropriate.
   - Cooperate and coordinate with same-jurisdiction regulatory authorities to improve system-wide views of climate-related risks.
   - Engage in discourse on home-host coordination through channels such as institution-specific supervisory colleges.

3. **Early consideration of other potential macroprudential policies and tools to address systemic risks.** FSB suggests that microprudential tools alone may be insufficient to address the cross-sectoral, global, and systemic dimensions of climate-related risks. Therefore, the FSB report "presents some of the early thinking among existing literature and work of standards setting bodies and authorities on macroprudential policies and tools,

and trade-off considerations" that supervisors and regulators can consider when facing systemic risks that are not fully addressed by current measures. FSB recommends supervisors and regulatory authorities, as well as standard-setters and international bodies, conduct research and analysis in order to sufficiently account for unique climate-related risks and identify ways to improve the regulatory supervisory frameworks.

The FSB has invited public commentary on this report through June 30, 2022 and has provided a set of questions for entities to consider. Final recommendations are expected to be published in Q4 2022.

Principles for climate-related risk management for large banks: OCC and FDIC proposals

The OCC and FDIC separately issued draft principles geared toward supporting large financial institutions in establishing high-level framework for "safe and sound management of exposures to climate-related financial risks," consistent with the agencies' existing risk management frameworks as described in their rules and guidance. Each of these releases outlines a climate-related risk framework comprised of six general principles:

— Governance
— Policies, procedures, and limits
— Strategic planning
— Risk management
— Data, risk measurement, and reporting
— Scenario analysis.

The agencies further propose principles for assessing climate-related risk across six risk categories, including:

— Credit
— Liquidity
— Other financial
— Operational
— Legal and compliance
— Other nonfinancial.

The comment period for the OCC's release (*see KPMG Regulatory Alert, here*) has closed. Comments on the FDIC's proposal will be open through June 3, 2022.

Separately, the OCC also outlined key questions issued for boards of directors to ask of senior management related to climate change and associated financial risks. The OCC indicated that the questions were intended to promote and accelerate improvements in climate-risk management practices at large banks. (*See KPMG Regulatory Alert, here*.)

Relevant KPMG Regulatory Insights thought leadership:

— KPMG Regulatory Alert: OCC Principles for large bank climate risk management
— KPMG Regulatory Alert: Board action: Climate risk questions for management
— KPMG Regulatory Alert: Climate Scenario Analysis
— KPMG Regulatory Alert: Climate risk: SEC's mandatory climate disclosure proposals
— KPMG Regulatory Insights POV: Operationalizing climate risks

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