Assessment of the Financial Stability Oversight Council's Report on Climate-Related Financial Risk

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On October 21, 2021, the Financial Stability Oversight Council (FSOC), chaired by Treasury Secretary Janet Yellen, issued the Report on Climate-Related Financial Risk called for by Section 3 of President Biden's May 2021 Executive Order on Climate-Related Financial Risk. Although the report represents important progress and outlines a handful of immediate steps, Secretary Yellen and the FSOC missed a key opportunity to chart a comprehensive course to mitigate climate risk. President Biden must appoint regulators to all the independent agencies who will immediately implement what is in this report, which mostly involves data collection and analysis, and then begin actually mitigating climate risk to the financial system.

Overview of Successes and Shortcomings

Secretary Yellen's most important success in the FSOC report was obtaining acknowledgement from almost all financial regulators that climate-related financial risk is "an emerging threat to the financial stability of the United States." Following the White House's determination that climate change poses "serious and systemic risks" to the U.S. economy and financial system, this report places climate among the threats that U.S. financial regulators recognize as significant enough to upend the entire financial system. Recognition of the systemic nature of the threat creates a responsibility for each FSOC member, as well as the Council as a body, to use all tools within their remit to protect the financial system and broader economy.

The report rightly states that "the need for better data and tools cannot justify inaction, as climate-related financial risks will become more acute if not addressed promptly." But its recommendations for regulators fail to embody this precautionary principle. Instead of recommending or even endorsing specific mitigatory steps, it establishes new working groups and stakeholder processes and commends the disclosure and assessment rulemaking processes and requests for information already underway at the Securities and Exchange Commission (SEC) and Federal Housing Finance Agency (FHFA). The report does not assert that disclosure and assessment will by themselves reduce climate risk, yet these are the only supervisory and regulatory tools that it recommends or endorses explicitly. It also encourages banking regulators to consider incorporating climate risk into their supervisory reporting and oversight, but only in highly qualified terms. The limited scope of these recommendations is a missed opportunity to kickstart progress on actually mitigating climate risk.

Risk-reduction tools such as enhanced capital requirements and portfolio limits are well-established in banking regulation, and foreign regulators are already considering their use to mitigate climate risk. There is no excuse for neglecting to mention them.

The document is also silent on the role of fossil fuels and other drivers of climate risk, essentially ignoring President Biden's call for agencies to mitigate climate-related financial risk "and its drivers." Given that U.S. banks are the world's largest financiers of fossil fuel expansion and thus key drivers of climate risk, financial regulators must make reckless fossil fuel lending a central focus of any climate risk strategy aimed at the financial sector.

In the face of an urgent need for action, this report is a tiny step forward for lagging U.S. financial regulators, even as their leading international counterparts make bigger strides. In the week leading up to COP26, the Bank of England announced it is considering capital buffer rules for banks to cover climate risks, and the UK Treasury announced it will soon require large public companies to disclose mandatory net zero transition plans or explain their noncompliance. And as noted by the FSOC report, central banks around the world are already issuing supervisory guidance and conducting climate scenario analyses and stress tests. To show leadership on climate-related financial risk, U.S. financial regulators must accelerate action on risk reduction, not just disclosure and assessment.

Priority Next Steps for President Biden and U.S. Financial Regulators

The White House, FSOC, or FSOC members should take the following actions immediately:

- **Nominate leaders who will fulfill financial regulators' obligation to mitigate climate-related risk.** President Biden must appoint financial regulators who share his priority of mitigating climate-related financial risk and its drivers. Along with accelerating confirmation of his excellent slate of announced nominees to FSOC agencies, President Biden must make the right appointments to the Federal Reserve, for the upcoming Chair vacancy and up to three more seats, including a Vice Chair and Vice-Chair for Supervision. To date, the Federal Reserve has dragged its feet on climate risk. President Biden must move quickly to nominate diverse leadership committed to addressing climate-related systemic risk to all of the openings at the Fed, and the Senate must move quickly to evaluate the President's nominees and vote on them.

- **Incorporate racial and economic justice into climate workstreams.** The FSOC and each member agency must incorporate and prioritize policy solutions that promote racial, economic, and environmental justice within all climate workstreams. The report briefly mentions financially vulnerable communities and communities of color, as well as FHFA's Request for Information on fairness and equity, but it does not recognize how climate financial risks are systematically convolved with racial and economic inequality. Nor does it identify the ways that racial and economic justice must be incorporated into each agency workstream to protect the financial system and build a more fair, resilient, and equitable economy.

- **Issue supervisory guidance.** Bank regulators must move quickly to issue written guidance to banks regarding the climate-related issues that examiners will evaluate and set clear expectations. In a recent letter, NGOs highlighted key issues that must be evaluated, such as how climate change increases credit risk, market risk, liquidity risk, and operational risk for financial institutions. Because supervisory guidance is iterative and informal, it can be updated as initial examination results and new modelling become available.

- **Conduct scenario analyses and stress tests.** The FSOC endorses scenario analysis as a tool for assessing climate risk, but stops short of recommending that regulators immediately mandate this analysis or integrate it into ongoing stress tests. Bank regulators should draw on lessons from counterparts in Europe and elsewhere to immediately begin integrating climate risk into their periodic stress testing of banks and begin conducting scenario analyses.

- **Begin taking action to mitigate climate-related systemic risk.** Regulators around the world increasingly recognize that banks' continued financing of fossil fuel expansion is worsening the carbon bubble, a key source of systemic risk. Legislators and regulators in the UK, the EU, and Connecticut are adopting policies that will make financial institutions more resilient to the risks posed by the climate crisis and clean-energy transition, and also reduce their contributions to the *drivers* of that risk. These tools include higher capital risk weights for toxic fossil fuel assets, capital surcharges for the largest funders of fossil fuels, portfolio limits on the riskiest assets, and net zero transition plan requirements. The sooner regulators act to meaningfully limit the drivers of climate risk, the greater the likelihood of a smooth transition to a financial system aligned toward 1.5°C.

- **Require public and private companies to disclose climate-related risk.** By early 2022, the SEC should release a proposal for climate-related disclosures, which must provide a clear, science-based framework for disclosure by financial as well as non-financial institutions, and by large private companies and funds as well as public companies. This disclosure must include all material risks, including Scope 3 emissions, financed emissions and emissions from activities for which the issuer has provided insurance.

- **Write standards for ESG claims by fund managers and investment advisors.** The SEC should propose a rule to address ESG claims by fund managers and investment managers. The administration is staking its climate promises on activating private financial flows, but the vast majority of climate-themed funds are not aligned with Paris climate targets. To rein in greenwashing by asset managers and avoid climate-concerned investors inadvertently contributing to climate risk, the SEC must establish standards for ESG data disclosure by fund managers and standardize naming conventions.

Additional priority actions for financial regulators to address climate risk are outlined here.

Scorecard on the Report's Handling of Key Needs and Expectations

An October 2021 report from Public Citizen and Americans for Financial Reform summarized expectations that civil society groups have made to Treasury and the FSOC regulators for what to include in the report. We use the following scoring system to evaluate how it measured up to those expectations:

Green (Favorable) = Report acknowledges need/expectation and recommends a solution

Yellow (Mixed) = Report acknowledges need/expectation but does not recommend a solution

Red (Unfavorable) = Report does not acknowledge need/expectation

As shown below, we conclude that the FSOC's handling of only two points warranted a finding of a Favorable (Green). Nine needs and expectations warranted a finding of a Mixed (Yellow), and the FSOC's handling of the remaining 18 issues warranted a finding of an Unfavorable (Red).

What was needed and expected...	What the FSOC report said...
Report highlights the severity and urgency of the climate crisis and its financial and economic significance.	The report discusses the financial and economic risks of climate change but doesn't adequately convey a sense of urgency. For example, it does not discuss the limited time remaining for a viable pathway to the internationally agreed 1.5°C target and it provides no timeline for action.
The report recognizes fossil fuels are a primary driver of climate change.	Fossil fuels are not identified as a driver of climate risk.

The report states that new oil and gas exploration and development are incompatible with a 1.5°C pathway.	The report mentions neither the 1.5°C target nor that continued oil and gas exploration will prevent meeting this target.
Precautionary approach: Report recognizes that immediate action is necessary even in the absence of complete information.	The report says data gaps do not justify delaying action on climate-related financial risk. Its recommended actions, however, focus solely on gathering data and assessing and disclosing risk.
Provide specific timelines for regulatory action.	No specific timelines for regulatory action are provided.
Report recognizes the intersection of climate-related financial risk with racial, environmental, and economic justice and prioritizes risk mitigation and increased resilience for marginalized communities.	The report briefly mentions financially vulnerable communities and communities of color and FHFA's Request for Information on fairness and equity.
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 report discusses the principles of incorporating climate risk into the traditional risk management framework used by examiners. However, it fails to recommend use of these tools. Instead it refers to study processes already underway and states that agencies should consider whether new supervisory guidance is needed.
Climate risk should be part of periodic stress tests banking regulators and FHFA use to assess how banks and GSEs will fare under crisis conditions.	Climate risk stress testing is mentioned but the report does not recommend incorporating it into periodic stress tests. The report implies that data is insufficient to carry out climate risk stress tests at this time.
Regulators should use longer-term scenario analysis exercises to complement stress tests.	The report promotes the use of scenario analysis to assess risk, noting that it has been a useful experience in other countries for identifying data and modeling needs.
The CFTC should incorporate climate risk into supervisory stress tests.	While the report acknowledges that derivatives prices are highly volatile, it fails to discuss the potential for climate risk stress tests by the CFTC. Instead it suggests that market participants stress test themselves.
Climate risk should be part of "call reports" that banks file with regulators about their financial condition.	The report recommends only that regulators consider whether to update banks' reporting requirements around climate risk.

The Federal Reserve should consider imposing a climate-risk surcharge on global systemically important banks (GSIBs) to reflect additional systemic climate risks that the largest banks face and pose.	No mention of surcharges.
Banking regulators should require banks to hold more capital to offset riskier carbon-intensive assets or those exposed to heightened physical risks.	No mention of capital requirements.
Regulators should recognize the fossil fuel sector's long-term volatility and decline and tighten concentration limits for bank exposure.	The report mentions credit concentration risk but does not discuss concentration limits or any other solution.
Regulators should prevent unacceptably risky climate-related lending using portfolio limits and their authorities to prohibit unsafe and unsound practices.	No mention of portfolio limits.
The FDIC should adjust deposit insurance premiums to reflect climate risks to banks.	No mention of deposit insurance.
The Treasury Secretary, OCC, and Fed should 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.	No mention of possible limits on activities relating to physical commodities or merchant banking.
The CFTC should ensure firms and markets most exposed to climate risk are adequately protected by adjusting capital and margin requirements.	No mention of capital and margin requirements.
Future bailouts should be designed to protect workers and the public from the harms caused by continued support for fossil fuels. The Treasury Secretary and Fed should establish safeguards to this end.	No mention of emergency lending, lending facilities or other bailouts.
Regulators should use Dodd-Frank authorities to incorporate climate risk into nonbank SIFI designation and regulation and include climate in a reinvigorated Volcker Rule.	No mention of SIFI designations (other than to note that many designated banks are concentrated in NYC and face extreme weather risk). No mention of the Volcker Rule.

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.	The report endorses SEC’s ongoing disclosure rulemaking for public companies but ignores the need for greater climate risk disclosure by private companies and funds.
The SEC should update accounting, audit and enforcement standards for climate risks, ESG claims, and material omissions in disclosures.	A footnote mentions the failures of the accounting and auditing industries to address climate risk and acknowledges the SEC has an enforcement task force focused on climate risk. However, the report does not discuss significant discrepancies between financial statements and annual reports or the potential for significant concealment of climate risk (e.g., overstated valuations of fossil fuel reserves). There is no recommended action in this area; the report simply praises the efforts of an international body, the IFRS Foundation.
The SEC and banking regulators should revise Industry Guidance for bank holding companies and the major industries that they invest in or rely on (oil and gas, real estate, property-casualty insurance underwriting).	No mention of Industry Guidance.
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.	No mention of PCAOB. The report cites an NGFS study identifying the need for greater assurance about the quality of climate-related data through verification and audit mechanisms, but doesn't call for any action.
The SEC should standardize ESG definitions, criteria, and disclosures by fund managers and registered investment companies.	The report praises SEC's plan to launch a rulemaking on ESG disclosures by fund managers.
The SEC should ensure that shareholders are able to raise ESG-related proposals and use proxy advisory firms to exercise their right to vote.	No mention of shareholder voting rights.
The SEC could require investment advisors to adopt and implement sustainable investment policies, and to disclose in prospectuses how they address ESG issues.	The report praises SEC's upcoming rulemaking on disclosures for ESG-labelled funds and its recent Risk Alert on this topic, but it is silent on sustainable investment policies for investment advisors and standardization of ESG treatment across their managed funds.

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.	No language on credit ratings firms.
The CFTC could initiate rulemaking to stop market participants from speculating in climate-related derivatives if they might increase systemic risk.	The report is silent on the problem of speculation in the derivatives market. This is particularly problematic given that net-zero pledges based on highly volatile offsets are proliferating, creating incentives for banks to build large-scale derivatives trading operations to speculate in this market.