STATEMENT OF

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on

"CLIMATE-RISK: ARE FINANCIAL REGULATORS POLITICALLY INDEPENDENT"

before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND MONETARY POLICY

of the

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Chairman Barr, Ranking Member Foster, and Members of the Subcommittee, I am pleased to appear at today's hearing to discuss the FDIC's approach to addressing the financial risks posed by climate change.

The FDIC's core mission is to maintain stability and public confidence in the U.S. financial system. The agency carries out this mission through its responsibilities for deposit insurance, banking supervision, and the orderly resolution of failed banks, including systemically important financial institutions. The agency's role with respect to climate change is centered on the financial risks that climate change may pose to the banking system, and the extent to which those risks impact the FDIC's core mission and responsibilities.

My testimony today will provide a general discussion of the FDIC's understanding of climate-related financial risks; the FDIC's efforts to collaborate on this topic with other Federal agencies, industry stakeholders, and international organizations; and the agency's first steps to support financial institutions as they develop plans to identify, monitor, and manage the financial risks posed by climate change.

I would emphasize to the Subcommittee that the FDIC is not responsible for climate policy. As such, the FDIC will not be involved in determining firms or sectors with which financial institutions should do business. These types of credit allocation decisions are the responsibilities of financial institutions. The FDIC's approach is centered around having financial institutions fully consider climate-related financial risks—as they do all other risks—and continue to take a risk-based approach in assessing individual credit and investment decisions.

Addressing the Financial Risks Posed by Climate Change

There is broad consensus among financial regulatory bodies, both domestically and abroad, that the effects of climate change and the transition to reduced reliance on carbon-emitting sources of energy present unique and significant economic and financial risks, and therefore, an emerging risk to the financial system and the safety and soundness of financial institutions.

The financial system has always had severe weather events to contend with and, thus far, the banking industry has handled these events well.[1] Agricultural banks are familiar with the effects that drought conditions can have on farming communities; banks in the west understand the impacts of wildfires; and coastal banks have long responded to the annual threat of tropical storms and hurricanes.

However, changing climate conditions are bringing with them challenging trends and events, including rising sea levels, increases in the frequency and severity of extreme weather events, and other natural disasters.[2] These trends present emerging financial risks to the safety and soundness of financial institutions. The goal of the FDIC's work on climate-related financial risks is to ensure that the financial system continues to remain resilient despite these rising risks.

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[1] See FDIC Staff Studies (June 2022), "Report No. 2022-03: Severe Weather Events and Local Economic and Banking Conditions," available at https://www.fdic.gov/analysis/cfr/staff-studies/2022-03.pdf.

[2] See Intergovernmental Panel on Climate Change (2021; in press), "Summary for Policymakers," in V. Masson-Delmotte, P. Zhai, A. Pirani, S.L. Connors, C. Péan, S. Berger, N. Caud, Y. Chen, L. Goldfarb, M.I. Gomis, M. Huang, K. Leitzell, E. Lonnoy, J.B.R. Matthews, T.K. Maycock, T. Waterfield, O. Yelekçi, R. Yu, and B. Zhou, eds., Climate Change 2021: The Physical Science Basis. Contribution of Working Group I to the Sixth Assessment Report of the Intergovernmental Panel on Climate Change (Cambridge, United Kingdom: Cambridge University Press).

Defining Climate-Related Financial Risks

Financial institutions are likely to be affected by both the physical risks and transition risks associated with climate change. Together these are generally referred to as climate-related financial risks.

Physical Risks

Physical risks generally refer to the harm to people and property arising from acute, climate-related events, such as hurricanes, wildfires, floods, and heat waves, as well as chronic shifts in the climate, including higher average temperatures, changes in precipitation patterns, sea level rise, and ocean acidification.

For example, acute physical risks, such as flooding, hurricanes, wildfires, and droughts, may result in sudden, significant, and recurring damage to properties securing exposures held by financial institutions or may otherwise disrupt the operations of their business clients. Some of these properties may currently be considered to be outside of flood plains or in areas less prone to this type of damage.

Longer-term physical risks, such as rising average temperatures and sea levels may increase the risk to property values and drive changes to population growth and economic activity in certain areas, which in turn may result in detrimental impacts to household wealth, corporate profitably, local economies, and municipalities. Further, growing physical risk impacts, including their economic costs, may also have an increasing influence on behavior as individuals and businesses prioritize geographic areas less exposed to physical risks.[3]

While current insurance coverage may mitigate some or all of the loss associated with many severe weather events, policies may become more expensive over time or may become

[3] See National Bureau of Economic Research (2021), Residential Property Markets and Exposure to Rising Sea Level.

unavailable altogether to cover losses for a particular geographic area or business activity, particularly if faced with increasing severity and frequency of severe weather events.[4]

Additionally, while the U.S. government may provide assistance to cover the costs associated with many severe weather events, financial institutions should not be wholly dependent on this assistance, whether directly or indirectly, to manage the risk of loss from such events.

Transition Risks

In addition to physical risks, transition risks may also pose material risks to financial institutions' financial condition in several ways. Transition risks generally refer to stresses to certain financial institutions or sectors arising from the shifts in public investment, consumer and business preference, or technologies associated with a transition toward reduced carbon reliance.

Public or private spending designed to reduce carbon emissions or mitigate the risks of climate change, technological advances, and changes in investor and public preferences may all contribute to and accelerate a transition to a lower-carbon economy.[5]

Advancements in technology have the potential to accelerate the development of lower-carbon energy sources, for example, if investor and public preferences and behavior results in a shift towards more energy efficient assets and companies earlier than otherwise expected.

In each case, certain companies or sectors may face increased competition or lowered revenue, resulting in reduced profitably and ability to repay obligations, as well as reductions in the value for certain assets that are less productive in a lower-carbon environment.

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[4] See California Department of Insurance (2018), "Insurance Commissioner Dave Jones Releases Report Addressing Fire Insurance Availability Issues," press release, January 4; and California Department of Insurance (2021), "Wildfire Survivors Now Covered by New Insurance Protections," press release, July 27.

[5] Reductions in carbon emissions are often considered through a "carbon equivalence amount," which measures the emissions of various greenhouse gases in terms of their equivalent amount of carbon dioxide with the same global warming potential. For example, see Equation A-1 in 40 CFR Part 98.

Increasing marketplace demand for the evaluation and disclosure of climate-related financial risks may influence investment decisions made by broader market participants, or result in a shift in market, consumer, or investor preferences that may trigger material decreases in the value of certain assets or groups of assets on their balance sheet and contribute to broader volatility of portfolio performance.

Further, climate-related financial risks are increasingly reflected within the assessment of credit quality of corporate, sovereign, and municipal exposures, as credit rating agencies and investor due diligence processes begin to reflect these risks in investment decisions.

It has become increasingly clear that climate-related financial risk poses a significant near- and long-term risk to the U.S. financial system and, by extension, may pose a risk to safe and sound banking and financial stability if it is not properly assessed and managed by financial institutions.

A Cross-Disciplinary, Interagency Approach with International Engagement

In order to understand and address the financial risks that climate change poses to financial institutions and the financial system, the FDIC has undertaken efforts to foster an open dialogue with our counterparts in the U.S. and international financial regulatory bodies, and especially with stakeholders throughout the banking industry. It is for these reasons that the FDIC established an internal, cross-disciplinary working group to assess the safety and soundness and financial stability considerations associated with climate-related financial risk and to develop an agency-wide understanding of climate-related financial risk. The FDIC is also coordinating with our interagency peers and is participating on the Financial Stability Oversight Council's (FSOC) Climate-related Financial Risk Committee. The FSOC's work includes assessing climate-related risks to the financial system, facilitating information sharing and

coordination, and coordinating efforts to address data gaps. Further, as climate change is a matter of international attention, the FDIC, along with the Federal Reserve and the Office of the Comptroller of the Currency (OCC), have joined the Network of Central Banks and Supervisors for Greening the Financial System (NGFS) to foster collaboration and share best practices in addressing climate-related financial risks on a global basis. This complements our existing work with the Basel Committee's Task Force on Climate-related Financial Risks.

Proposed Statement of Principles for Climate-Related Financial Risk Management

While the FDIC remains in the early stages of addressing climate-related financial risks, regulators need to work with the banking industry now to support financial institutions as they develop plans to identify, monitor, and manage the risks posed by climate change. This collaboration should be conducted in a manner that is flexible enough to allow for change as knowledge is gained, data are developed, and new methodologies and tools are explored. Consistent with this approach, the FDIC issued a request for comment in April 2022 on draft principles that would provide a high-level framework for the safe and sound management of exposures to climate-related financial risks for large financial institutions.[6] Comments received on the proposed principles are currently under review and consideration.[7]

The principles take a risk-based approach, and are consistent with the risk management framework described in existing FDIC rules and guidance.[8] Notably, while the FDIC views climate-related financial risks as potentially impacting all financial institutions, regardless of

[6] See FDIC "Request for Comment on Statement of Principles for Climate-Related Financial Risk Management for Large Financial Institutions" (April 4, 2022), available at https://www.fdic.gov/news/financial-institution-letters/2022/fil22013.html.

[7] The window for comment submission closed on June 3, 2022. Comments received are available at https://www.fdic.gov/resources/regulations/federal-register-publications/2022/2022-statement-principles-climate-related-financial-risk-management-3064-za32.html.

[8] The FDIC has established standards for safety and soundness, as required by section 39 of the Federal Deposit Insurance Act, in Part 364 of FDIC Rules and Regulations, available at https://www.ecfr.gov/current/title-12/chapter-III/subchapter-B/part-364.

size, the draft principles are intended for large financial institutions, those with more than $100 billion in total consolidated assets.

The principles are intended to support efforts by financial institutions to focus on the key aspects of climate-related financial risk management. The request for comment includes general, high-level principles for incorporating climate-related financial risks into an institution's governance and risk management practices. The principles also address how climate-related financial risks could impact a financial institution's assessment of traditional risk areas, such as credit and other financial and nonfinancial risks, with respect to climate-related financial risks.[9]

The FDIC remains in the beginning stages of its work on climate-related financial risks, and will continue to expand its efforts to address these risks through a thoughtful and measured approach. With the issuance of its principles for comment in April of 2022, the FDIC has followed similar action of the OCC, which issued similar principles for comment in December of 2021, and has subsequently been joined by the Federal Reserve, which issued principals of its own in December of 2022. This represents an initial step toward the promotion of a consistent understanding of the effective management of climate-related financial risks. As all three agencies work together to finalize their proposed principles jointly, the FDIC will emphasize risk-based assessments and collaboration with other supervisors as well as with stakeholders in the banking industry, and our actions will complement actions that have been taken domestically and internationally. Importantly, the FDIC will continue to encourage financial institutions to consider climate-related financial risks in a manner that allows banks to prudently meet the financial services needs of their communities.

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[9] See *Statement of Principles for Climate-Related Financial Risk Management for Large Financial Institutions*, 87 Fed. Reg. 19507 (published April 4, 2022), available at https://www.federalregister.gov/documents/2022/04/04/2022-07065/statement-of-principles-for-climate-related-financial-risk-management-for-large-financial.

Conclusion

In conclusion, the FDIC recognizes risk management practices in this area are evolving. As I noted at the beginning of my testimony, the role of the FDIC with respect to climate change is limited to the financial risks that climate change may pose to the banking system and the extent to which those risks impact the FDIC's core mission and responsibilities.

The FDIC will continue to expand its efforts to address climate-related financial risks through a thoughtful and measured approach. The agency will emphasize risk-based assessments and collaboration with other supervisors and industry, and its actions will complement the actions taken domestically and internationally.

Importantly, the FDIC will continue to encourage financial institutions to consider climate-related financial risks in a manner that allows banks to prudently meet the financial services needs of their communities.

The FDIC remains committed to engaging with the public, industry stakeholders, and members of Congress on the issues outlined in my testimony. I look forward to answering your questions.