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CLIMATE TRANSITION AND THE FED

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The Federal Reserve Board (Fed) will substantially elevate the priority of climate-related risk in its regulations and supervision going forward. This paper explores the implications.

THE SHORT VERSION

The Fed will proceed methodically over a period of several years
Climate-related risk is a fairly new field and the Fed, and the banks it regulates, will need time to build their approaches and systems to do this right.

Its focus will be on financial stability
On climate risk, the Fed's focus is on the safety and soundness of banks and on overall financial stability risks. The Fed will explicitly not try to create a "climate policy" for its own sake.

The Fed is likely to focus on three broad stages, with some overlap in timing
These are:

- Creating a risk management framework
- Developing the necessary data
- Quantifying the size of climate-related risks

Public disclosures of bank exposures would come at the end of each stage
Key pieces of data are unlikely to be mandated for public disclosure until the Fed is quite comfortable with the validity and usefulness of the data. This would apply to quantification of risks as well.

Capital requirements for climate-related risk are some years off
The Fed is very unlikely to impose capital charges for this risk until it is comfortable with all three stages.

More aggressive steps are unlikely in the next few years
It is virtually certain not to forbid certain classes of loans or investments, such as those that support carbon-intensive projects or activities, for banks to own. It is also unlikely, in the next few years, to change its risk weightings of assets to reflect how climate-friendly they are, although this is more conceivable.

THE LONG VERSION

More focus at the Fed on climate-related risk is certain

The Biden Administration, and its appointees to the Fed Board, will push for more attention to climate-related risk. They will find that they are pushing on an open door, as evidenced by the Fed's most recent Financial Stability Review, which, for the first time, placed an emphasis on this risk. Further, the Fed just announced that it has joined the Network of Central Banks and Supervisors for Greening the Financial System (NGFS).

This impetus will be encouraged further by the Financial Stability Oversight Council, chaired by the Treasury Secretary, and by the US Securities and Exchange Commission (SEC) and other regulatory bodies once the Biden Administration appoints new leaders for them. All of this will be further reinforced by the strong, ongoing move in this direction internationally.

In other words, the Fed already wants to place more emphasis on climate-related risk for financial institutions and there is a very strong tailwind pushing them in the same direction.

Policy will be about financial risk, not "climate policy" for its own sake

The current Fed leadership views the central bank's role in this area as managing financial stability risk, rather than setting climate policy as a separate societal objective. This might shift as Biden appointees join the Board, but the Fed is likely to always place a high priority on maintaining its independence by not overstepping its mandate to manage monetary policy and financial stability risk. This constraint may be even stronger if Republicans do well in the 2022 midterm elections.

It is worth noting that the Fed's view is in the mainstream of central bank thinking. For example, it is also the official stance of the European Central Bank (ECB) under President Christine Lagarde, despite strong support in Europe for green activities generally.

Beyond financial stability risks, the Fed will eventually need to re-evaluate what securities it will own as part of its monetary policy and what collateral it will accept from banks. Should it rule out "carbon-intensive" assets and explicitly favor "green" assets? The current Fed team is unlikely to do this, but that could change with new appointments to the Board.

The Fed is likely to focus on three broad stages, with some overlap in timing

There would be an emphasis in the next few years on:

- Creating a risk management framework
- Developing the necessary data
- Quantifying the size of climate transition risks/running a climate "stress test"

The Fed is likely to pace itself as it ratchets up requirements on banks, in recognition of the fact that it takes time for organizations to build the internal infrastructures and teams of people necessary for new challenges such as this, as well as to gather the new data needed for this purpose. Further, international and domestic best practices are still evolving, which also encourages a step-by-step approach. For that matter, the Basel Committee on Banking Supervision, and other global bodies, may develop global minimum standards over time, which the Fed would be likely to apply in the US.

Supervision of climate-related risk management

The Fed already made clear in its November 2020 Financial Stability Review that the climate transition creates risks for banks and that it is the responsibility of bank managers and boards to manage this risk. Some banks were already taking this risk seriously, but supervisory emphasis by the Fed would certainly add further impetus and most would agree that even the leading banks have considerably more to do over time.

There is a great deal that the Fed could accomplish through overall supervisory guidance and through supervision of individual banks. Minimum requirements and best practices could be laid out, including a requirement to have involvement of sufficiently senior executives in the risk review process. Failures to meet these requirements would result in supervisory pressure or, eventually, sanctions. The Fed would strive to avoid being too punitive in this relatively new area of risk management, but would increase the level of pressure as the general level of bank expertise improved.

Data requirements and disclosures

A key part of risk management is clearly having the right data to understand the risks. The Fed is bound to issue supervisory guidance in this regard and to expand it over time as best practices develop. There is likely to be an evolution over time. Initially, the push will be for banks to develop the data they feel they need to appropriately manage the risk, with some of this reported to the Fed. The next step would be for the Fed to standardize some of these measurements and require banks to report on that basis to the Fed itself. Finally, new public disclosure requirements may result, once the Fed is confident that the measures make sense and that the underlying data is reasonably accurate. Such disclosures should be coordinated with the US Securities and Exchange Commission (SEC), which will doubtless be making its own moves towards increased and more standardized disclosure requirements. There will also be important non-governmental players, such as the rating agencies, which will have their own ideas on disclosures.

This paper focuses on the Fed, but the SEC in particular can play a large role in transforming corporate behavior through its disclosure requirements for all publicly traded companies and many types of investment funds.

Climate stress test

There is considerable pressure for the development of climate stress tests that can quantify the overall financial stability risks of the climate transition. However, the Fed and other central bankers are also keen to ensure that such tests do not harm their existing bank stress tests. Calling both items “stress tests” can imply much more similarity than actually exists between these exercises and could lead to misguided pressure to combine the climate transition risks directly into existing stress tests. In reality, they are very different animals.

For example, Federal Reserve governor Lael Brainard in a recent speech alluded to “the different nature of climate-related risks relative to financial and economic downturns and [their] significantly longer planning horizons[1]”. She also discussed the heavy reliance of traditional stress testing on historical data versus the unprecedented nature of the climate transition, which constrains the usefulness of historical data.

The Bank of England’s climate stress test is scheduled for 2021. The Fed’s first version is more likely to be 2023 or later. Banks need time to develop the underlying data and risk models, the Fed needs to think through its overall approach to climate transition risk management, and it will doubtless want to learn from the Bank of England’s experience, and that of other jurisdictions.

Further, the initial version is unlikely to produce any legally binding capital requirements, unlike the existing stress tests focused on traditional financial risks. The Fed would want some experience with its climate stress test before using it to quantify binding requirements. Based on that experience, it will need to decide whether capital requirements are an appropriate tool for managing climate-related risk. There would certainly be pressure from many in the relevant political, academic, and media communities to create such requirements. These voices would argue that a banking risk that can be quantified ought to have commensurate capital requirements and that banks will not take these risks sufficiently seriously without capital requirements. The main counterarguments are likely to be that the lack of historical experience with these risks, their unpredictability, and their sheer complexity make capital requirements an inappropriate tool.

Assuming the Fed chooses to impose capital requirements, there will be questions of how best to combine this with other capital requirements. Would it be a simple add-on or would the combination be more complex? There is likely to be a relatively low correlation between the conditions that create extreme stress for a bank under standard stress tests and those that create high stress on climate transition risk. Therefore, it may not make sense to simply add the capital requirements from the two tests together.

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1. Address by Governor Lael Brainard to the Center for American Progress, December 18, 2020, as taken from the Fed’s website.

Differing risk weights for "green" and "carbon-intensive" activities

There is considerable international discussion about incorporating climate transition risk into the risk weights used in capital requirements. For example, lending to "green" projects or companies would have a lower risk weight than lending to "carbon-intensive" ones. This could be done by keeping green risk weights at the level of current risk weights and adding a surcharge for "carbon-intensive" ones or by setting "green" risk weights lower than the current level and "carbon-intensive" ones higher.

The current Fed team does not seem inclined to go in this direction, believing that it is too difficult and complex a task, and too prone to politicization, to be worth the benefits. Most likely they would try to achieve the same overall goal, of creating incentives to reduce climate-related risk, through supervisory practices and the climate stress test.

A more extreme approach than revising risk weights would be to create absolute prohibitions against loans to "carbon-intensive" activities. The current Fed team would almost certainly not do this and it is difficult to see future Fed leadership doing this either, at least anytime soon.

CONCLUSIONS

There is certain to be much greater emphasis on climate-related risk at the Fed going forward, as well as at other regulators. This will be phased in over time, but will become a major factor in how banks manage these risks.

Douglas Elliott is an Oliver Wyman partner focused on the intersection of Finance and public policy. He is the author of the book, *Uncle Sam in Pinstripes: Evaluating US Federal Credit Programs*. Prior to his current position, he was a scholar at the Brookings Institution and a Visiting Scholar at the IMF. Before that, he was the founder and principal researcher for the Center On Federal Financial Institutions. He began his career with two decades as an investment banker, primarily at JP Morgan.

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