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A Harbinger of Things to Come? New York DFS Outlines Expectations for Regulated Entities on Financial Risks Arising from Climate Change

This client alert, part of a series focused on ESG disclosure and regulatory developments, should be read together with our ESG Lexicon, available here, which provides definitions of some of the key terms used in ESG reports, disclosures and regulations.

Key Takeaways

- *The New York State Department of Financial Services ("DFS"), issued a letter to DFS-regulated banks and non-bank institutions discussing the financial risks of climate change and outlining its expectations with respect to risk management processes, governance frameworks and business strategies.*
- *While the letter imposes no deadlines, DFS-regulated institutions should consider how to address DFS's expectations, including its call for enterprise-wide risk assessments on the impact of climate change on the institution's risk factors, such as credit risk, market risk, liquidity risk, operational risk, reputational risk and strategy risk.*
- *DFS is the first U.S. regulator of financial institutions to publish expectations for regulated institutions in relation to climate change risk management.*

Executive Summary

On October 29, 2020, DFS published an industry letter (the "Industry Letter") for banks and other financial institutions that it regulates that details the range of climate change risks that could soon impact these institutions.[1] The letter is addressed to both DFS-regulated banking institutions and non-bank institutions, such as money transmitters and virtual currency companies. The letter sets forth DFS's expectations that banking institutions begin to address the financial risks from climate change in their risk management processes, governance frameworks and business strategies, including by designating a board member or committee and members of senior management as accountable for this issue and undertaking an enterprise-wide risk assessment. With respect to non-depository institutions, DFS expects that they conduct a comprehensive risk assessment related to climate change and begin to develop strategic plans in order to mitigate such risks. While DFS does not establish specific deadlines or timetables for incorporating climate change considerations into institutional risk management and business strategies, it indicates that

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it may pursue greater alignment with international standards regarding such matters. These efforts may include working in concert with its counterparts to develop practices to supervise management of risks associated with climate change by regulated banks and other institutions.

Growing Calls for Financial Institutions to Address Climate Change

Outside of the United States, banking regulators have urged action related to the financial risks that could arise due to climate change. Central banks and financial regulators around the world have joined the Network of Central Banks and Supervisors for Greening the Financial System ("NGFS"), an organization that now consists of 75 members and 13 observers.[2]

U.S. regulators are sharply increasing their focus on this issue. The Federal Reserve has recently applied to join the NGFS,[3] following earlier statements from Chairman Jay Powell noting that climate change may pose a system-wide financial stability risk.[4] The Federal Reserve examined climate change risks in its twice-yearly financial stability report for the first time in November 2020,[5] accompanied by a statement by Governor Lael Brainard in support of this addition.[6] Senior officials at the Federal Reserve Bank of New York and the Federal Reserve Bank of San Francisco have addressed financial risks posed by climate change in speeches.[7] An advisory committee to the Commodity Futures Trading Commission issued a report in September 2020 detailing the threats presented by climate change to the U.S. financial system.[8] To date, the Securities and Exchange Commission has only issued general guidance regarding climate change disclosures, but at least two Commissioners have publicly expressed their view that the SEC must modernize its disclosure regime in relation to climate change; one Commissioner noted this was necessary in order to "ensure that financial institutions produce standardized, comparable, and reliable disclosure of their exposure to climate risks."[9]

DFS has paid particular attention to the potential risks of climate change on financial institutions. In 2019, DFS became the first U.S state banking regulator to join the NGFS. In September 2020, DFS issued a letter to New York insurance companies that outlined DFS's expectations for the industry's management of financial risks from climate change.[10] One month later, DFS issued the Industry Letter.[11]

DFS Outlines Financial Risks Related to Climate Change

The Industry Letter begins with a survey of the types of climate change risks that could impact the affected industries. In particular, it highlights "physical risks" (risks related to damage to property or assets caused by severe weather events and long-term shifts in climate patterns) and "transition risks" (risks impacting the value of assets that arise from the potential for loss caused by a shift toward a lower-carbon economy, driven by policy, regulations, advances in low-carbon technology, consumer sentiment and liability concerns).

Physical risks can impact the value of properties and assets, cause business and supply chain disruption, and impose costs in connection with recovery from natural disasters. Examples of assets that could face physical risks due to weather events include mortgage loans, commercial real estate loans, agricultural loans and derivatives portfolios. These, in turn, could increase default rates, reduce lending activity and reduce asset values. Flood risk, for example, could affect regional and community lenders, in particular.

With respect to transition risks, the Industry Letter highlights the risk of "stranded assets" – assets that "turn out to be worth less than expected as a result of changes associated with the energy transition."[12] It goes on to note that cumulative losses in affected sectors could have amplifying effects across the financial services sector, from direct lenders to wealth management portfolios, particularly when one factors in not only direct losses in affected sectors, but also indirect losses for sectors that rely on fossil fuel inputs. Moreover, DFS notes that virtual currency companies with high carbon footprints related to cryptocurrency mining could face a loss of investment and trading opportunities from institutional investors that are increasingly focused on building "sustainability and climate-integrated portfolios."[13]

DFS Expectations Related to Governance and Risk Management

Based on DFS's assessment of physical and transition risks, the Industry Letter indicates that DFS and other financial regulators have a responsibility to ensure that regulated institutions "have appropriate risk-management frameworks in place and are resilient to these risks."

The Industry Letter states that DFS expects that its regulated banks and other Regulated Organizations[14] should:

- start integrating the financial risks from climate change into their risk management processes, governance frameworks and business strategies. They should, for example, "designate a board member, a committee of the board (or an equivalent function), as well as a senior management function, as accountable for the organization's assessment and management of the financial risks from climate change." Such efforts should "include an enterprise-wide risk assessment to evaluate climate change and its impacts on risk factors, such as credit risk, market risk, liquidity risk, operational risk, reputational risk, and strategy risk"; and

- start developing their approach to climate-related financial risk disclosure, and should engage with the Task Force for Climate-related Financial Disclosures (the "TCFD" – for more on the TCFD, see our prior client alert here) framework and other disclosure initiatives.

DFS stated that all Regulated Non-Depositories[15] should conduct a risk assessment of the physical and transition risks of climate change, whether directly affecting them or indirectly affecting them through impacts on their customers or the communities they serve. This risk assessment should review "business disruptions, out-migrations, loss of income and higher default rates, supply chain disruptions, and changes in investor and consumer sentiments, and start developing strategic plans, including an outline of such risks, the impact on their balance sheets, and steps to be taken to mitigate such risks."

In the Industry Letter, DFS acknowledges the complexity of these issues, and that there is no one way to address climate change risks – how an organization should proceed depends on "size, complexity, geographic distribution, business lines, investment strategies, and other factors." This suggests DFS will take a tailored approach in assessing whether a regulated party's risk management is adequate. To enable regulated parties to assess and develop effective approaches to manage climate change risks, DFS offers suggestions for frameworks and guidance on the subject of climate-related financial risks, including the TCFD's Banking Programme Report[16] and the United Nations Principles for Responsible Investment (for more on these principles, see our prior client alert here).

Looking Ahead

DFS states that "the U.S. is behind our European counterparts in terms of climate-related supervision," and it is clear that DFS is staking out a position that is more aligned with U.K. and European approaches.[17] DFS also notes that it plans to work with "U.S. and international counterparts to develop effective supervisory practices," suggesting that the Industry Letter is an initial step in addressing management of financial risks of climate change by regulated institutions. Whether other states or the federal government will follow DFS remains to be seen. In the meantime, institutions to which the Industry Letter is directed now have DFS's roadmap as to governance and disclosure considerations, so as to be in a position "to prudently manage physical and transition risks from climate change." These institutions also should be aware that DFS is developing a strategy for integrating climate-related risks into its supervisory mandate, and should expect that supervisory practices, as well as guidance and best practice expectations, on this topic will continue to evolve.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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[1] New York Department of Financial Services, "Industry Letter – The Chief Executive Officers or the Equivalents of New York State Regulated Financial Institutions – Climate Change and Financial Risks" (October 29, 2020), available here.

[2] Members include the central banks of each of the G7 members states (other than the United States) and most members of the European Union, the European Central Bank, the People's Bank of China and Japan's Financial Services Agency) and 13 observers (including The Asian and Inter-American Development Banks, the Organization for Economic Cooperation and Development, the International Monetary Fund, and the World Bank Group's International Finance Corporation). *See* NGFS, "Membership" (as of October 30, 2020), available here.

[3] Rachel Frazin, "Federal Reserve applies to join group of banks managing climate risks" *The Hill* (November 11, 2020), available here.

[4] Katia Dmitrieva, "Powell Says Fed Is Likely to Join Group of Green Central Banks," *Bloomberg Green* (January 29, 2020), available here.

[5] The financial stability report includes a section titled, "The Implications of Climate Change for Financial Stability," which focuses on "how climate change, which increases the likelihood of dislocations and disruptions in the economy, is likely to increase financial shocks and financial system vulnerabilities that could further amplify these shocks." Board of Governors of the Federal Reserve System, "Financial Stability Report" (November 2020), available here.

[6] Brainard stated that it is "vitally important to move from the recognition that climate change poses significant financial stability risks to the stage where the quantitative implications of those risks are appropriately assessed and addressed." "Statement by Governor Lael Brainard" (November 9, 2020), available here.

[7] See Kevin J. Stiroh, Executive Vice President, Federal Reserve Bank of New York, "Climate Change and Risk Management in Bank Supervision: Remarks at Risks, Opportunities, and Investment in the Era of Climate Change, Harvard Business School, Boston, Massachusetts (March 4, 2020), available here (noting that the author is speaking for himself and that his "views do not necessarily reflect those of the Federal Reserve Bank of New York or the Federal Reserve System); Mary C. Daly, President and CEO, Federal Reserve Bank of San Francisco, "Why Climate Change Matters to Us: Speech at The Economics of Climate Change Conference" (November 8, 2019), available here.

[8] Climate-Related Market Risk Subcommittee, Market Risk Advisory Committee of the U.S. Commodity Futures Trading Commission, "Managing Climate Risk in the U.S. Financial System," (September 2020), available here.

[9] Commissioner Allison Herren Lee, "Playing the Long Game: The Intersection of Climate Change Risk and Financial Regulation," Keynote Remarks at PLI's 52nd Annual Institute on Securities Regulation (November 5, 2020), available here. Commissioner Caroline Crenshaw has also expressed concern about the SEC's "failure to addresss climate change risk." *See* Commissioner Caroline Crenshaw, "Statement on the 'Modernization' of Regulation S-K Items 101, 103, and 105," (August 26, 2020), available here.

[10] New York Department of Financial Services, "Insurance Circular Letter No. 15" (September 22, 2020), available here.

[11] Specifically, the Industry Letter is directed at "Regulated Organizations," which it defines as "New York regulated banking organizations, New York licensed branches, agencies of foreign banking organizations, New York regulated mortgage bankers and mortgage servicers, as well as New York regulated limited purpose trust companies," and "Regulated Non-Depositories (other than New York regulated mortgage bankers, mortgage servicers, and limited purpose trust companies)," which includes "New York regulated money transmitters, licensed lenders, sales finance companies, premium finance agencies, and virtual currency companies."

[12] "Industry Letter" (citing Carbon Tracker Initiative, Stranded Assets, August 23, 2017).

[13] The Industry Letter notes, "it is reported that the bitcoin network's consumption of energy on an annual basis represents a carbon footprint equivalent to that of New Zealand, and is equivalent to Venezuela's electricity usage" (citing Digiconomist, Bitcoin Energy Consumption Index, retrieved on October 20, 2020).

[14] See definition of "Regulated Organizations" in endnote [8].

[15] See definition of "Regulated Non-Depositories" in endnote [8].

[16] United Nations Environment Programme Finance Initiative, Task Force for Climate-related Financial Disclosures Banking Programme, "Charting a New Climate: State-of-the-art tools and data for banks to assess credit risks and opportunities from physical climate change impacts" (September 2020), available here.

[17] Another recent example of such approaches came on November 9, 2020, when the United Kingdom announced plans to require companies (including banks) to provide disclosures on the financial impacts of climate change on their businesses by 2025, becoming the first country to make climate-related disclosures mandatory. See HM Treasury, "Interim Report of the UK's Joint Government-Regulator TCFD Taskforce" (November 2020), available here.