Insight

FSOC Recognizes Climate Change as an Emerging Threat to the Financial System

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Executive Summary

- The Financial Stability Oversight Council (FSOC) released its Report on Climate-Related Financial Risk as part of a larger effort by the Biden Administration to institute climate change analyses throughout the executive branch.
- FSOC's report recommends practices to its member agencies to better account for the role of climate change within the financial sector such as data collection, disclosure requirements, and scenario analysis.
- With no legal enforcement power, FSOC's recommendations serve as additional messaging which at best highlight actions already underway at agencies and in industry.

Context

Following a Biden Administration executive order in May 2021 calling for the launch of a government-wide climate risk assessment, the Financial Stability Oversight Council (FSOC) has released its Report on Climate-Related Financial Risk, calling climate change an "emerging threat to the financial system." This report is the latest in a series of climate-related initiatives, the highlights of which include a commitment by the U.S. government to reduce greenhouse gas pollution by 50 to 52 percent by 2030, and the release of a sweeping " roadmap" identifying climate risk as "systemic" for the first time. While the release of the FSOC report is timely considering the United Nations Climate Change Conference next month, the report stops well short of what climate activists had hoped for, with a significant body of the report devoted to data-gathering recommendations.

The Report's Recommendations

The report makes four major policy recommendations, none of which have legal force; as the FSOC is not empowered to directly regulate activities across the financial system.

A New Climate-Related Financial Risk Committee

FSOC has committed to the formation of a Climate-related Financial Risk Committee (CRFC) that will "identify priority areas for assessing and mitigating climate-related risks to the financial system and serve as a coordinating body," sharing information where "appropriate." The committee will update FSOC semi-annually and will include a public summary of progress in the FSOC Annual Report. The CRFC will reportedly be the first formal committee formed by FSOC in a decade, and will be "guide[d]" by an ancillary Climate-related Financial Risk Advisory Committee (CFRAC).

While FSOC consolidating its climate-related expertise and creating a coordination hub in the form of a new committee appears sensible, this does raise the question as to how FSOC was tracking this "emerging risk" up until this point. FSOC's whole raison d'être is research and coordination with a view to identifying and preventing systemic shocks that could lead to catastrophic failure. The "news" then that FSOC will simply continue to serve this function, via the dizzying excitement of a new committee, would be baffling in any context, let alone as announced as FSOC's first recommendation of four.

Within this recommendation, FSOC also encourages the Federal Insurance Office (FIO), a subset of Treasury dedicated to monitoring the insurance sector, to "act expeditiously to analyze the potential for climate change to affect insurance and reinsurance coverage." This recommendation follows a similar plea made in the White House roadmap released a week prior, but in both cases the demand is slightly odd given steps FIO has already taken following the release of a request for information in August. As one of the few government bodies already taking actual steps and in the process of liaising with industry, these repeated instructions for action directed specifically at this relatively small part of Treasury are unusual to say the least.

FSOC Members Are Requested to "Fill Climate-related Data and Methodological Gaps"

FSOC recommends that its member agencies (including the Federal Reserve, Treasury, the Office of the Comptroller of the Currency (OCC), the Securities and Exchange Commission (SEC), and the Federal Housing Finance Agency (FHFA)) identify relevant climate-related data and develop a data collection plan where necessary to plug any gaps.

While the report recommends that FSOC member agencies coordinate with the CFRC to avoid duplication of effort, develop consistent data standards and metrics, and coordinate with relevant international bodies, it is less clear what FSOC might view as relevant climate-related data. The report attempts to provide some guidance on this, discussing among other suggestions various methodologies for measuring emissions and leveraging bank capital adequacy filings to identify portfolio exposures. Some of this detail might be useful to the FSOC member agencies in assessing their data and data needs; it is not clear, however, that this particular recommendation is fundamentally different from the same call to action issued to federal agencies by executive order in January, which *does* have legal force.

Public Climate-related Disclosures

FSOC members are encouraged to review their public disclosure requirements and consider updating them not simply on the grounds of utility but also for consistency and comparability. FSOC members are also directed to consider explicit disclosure of greenhouse gas emissions, a potential overreach on the part of FSOC given that the Environmental Protection Agency is one of the few federal agencies *not* to be a member of FSOC.

Note that this recommendation and the appropriate climate-related disclosures applies to the FSOC members themselves, and not necessarily the private actors these members oversee and regulate. Yet FSOC specifically draws attention and praise to the ongoing efforts by the SEC to develop a proposal on disclosure requirements for public issuers related to climate-related risks, and includes recommendations by industry. The federal banking regulators, for example, are encouraged to consider bank public reporting requirements to assess whether the current disclosure regime adequately provides market participants with climate-related financial risk information.

Assessing and Mitigating Climate-related Risks Via Scenario Analysis

FSOC recommends that its members collaborate with experts (nationally and internationally) to identify and develop climate forecasts and scenarios to better identify the exposure of regulated entities to climate-related risks. FSOC specifically recommends scenario analysis, similar to bank stress testing, to assess the ability of regulated institutions to cope in a variety of hypothetical climate scenarios.

Developing climate scenario analysis for banks is well underway both nationally and internationally. While an Accenture study in June this year of the largest U.S. banks suggested that 61 percent are already equipped to deal with climate-related stress testing (and, some argue, if climate-related risk is real then banks would be the first to be analyzing these risks simply as a matter of good underwriting). While the writing would seem to be on the wall as to the direction that U.S. federal banking regulators will move on this, significant concern remains in the industry as to the weakness, inconsistency, and lack of granularity of climate-related data available and the outsize regulatory burden these disclosures will impose on smaller actors.

Conclusions

Fundamentally, FSOC is in effect an advisory committee whose recommendations have no legal force and are at best that—recommendations. Climate activists hoping for stronger policy directives or regulatory disincentives for financial actors participating in financing the fossil fuel industry may have misunderstood the strength of the tools FSOC has at hand to effect real change. As such a “go slow” approach from FSOC focused on data gathering is not a surprise; that this is the limit of what FSOC is capable of producing does, however, refocus attention on its ability to in any way mitigate financial shock that could risk systemic collapse.