KPMG

Regulatory Alert

Regulatory Insights for Financial Services

October 2023

Final Principles for Climate-Related Financial Risk Management

Regulatory Insights:

- ***Interagency Coordination:*** *Under safety and soundness authority, the FRB, OCC, and FDIC issue final climate-related financial risk management principles for banks over $100B.*
- ***Risk-Based Approach:*** *Encourages a risk-based approach that:*
  - *Is related to customer relationships and the ability of the financial institution to manage such risks.*
  - *'Neither prohibits nor discourages providing banking services to customers of any specific class or type, as permitted by law or regulation.'*
  - *Complements (does not replace) the risk management framework described in the agencies' existing rules and guidance.*
- ***Final Modifications:*** *Final principles are very much in keeping with agency drafts with modifications in response to comments, including:*
  - *Clarification on the applicability to large FBOs.*
  - *Clarification on the role of boards of directors and management.*
  - *Removal of a reference in the FRB's proposal to compensation practices.*
- ***Principles & Cross-Risk Areas:*** *Expectations that:*
  - *Climate risk governance and management will evolve/mature across such areas as limits, planning, measurement, and analysis.*
  - *Span across risk areas (including credit, liquidity, operational, legal and compliance, and other financial and nonfinancial risks).*

The Federal Reserve Board (FRB), Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) (collectively, federal banking agencies or agencies) release final interagency guidance outlining principles for climate-related (physical and transition risks) financial risk management for large financial institutions.

In issuing the guidance, the agencies denote their authority relative to the safe and sound management of exposures to climate-related financial risks, 'consistent with the risk management framework described in the agencies' existing rules and guidance'. They add the final principles "neither prohibit nor discourage financial institutions from providing banking services to customers of any specific class or type, as permitted by law or regulation."

In final form, the interagency guidance is substantively similar to the drafts previously released by each of the federal banking agencies (each agency individually released a draft though all drafts were substantively similar to one another - see previous KPMG Regulatory Alert, here). Some modifications were made in response to comments provided, including:

— Clarification on the applicability to large foreign banking organizations (FBOs).
— Clarification on the role of boards of directors and management.
— Removal of a reference in the FRB's proposal to compensation practices.

The agencies recognize that all financial institutions, regardless of size, may have material exposures to climate-related financial risks. The principles, however, are issued specifically to large financial institutions with over $100 billion in total assets (including FBOs with combined U.S. operations of greater than $100 billion and any branch or agency of a FBO that individually has total assets of greater than $100 billion).

The integration of climate-related risks into risk management is expected to evolve over time and adapt to new developments and methodologies; risk management practices are expected to be scaled to the size, complexity, and risk profile of the financial institution. "The principles are intended to provide guidance to large financial institutions as they develop strategies, deploy resources, and build capacity to identify, measure, monitor, and control for climate-related financial risks."

The guidance includes six (6) general principles for climate risk management and discussion of the management of climate risk in six (6) specific risk areas.

General Principles for Climate Risk Management.

Principle	Description
1. Governance	**Board responsibilities:** — Be aware of the impact of climate-related risks on the institution and oversee management's implementation of strategies and risk management frameworks. — Allocate resources to support climate-related risk management. — Hold management accountable for adhering to established frameworks. — Acquire information to understand implications of climate risks across various scenarios and planning horizons, including beyond the "typical strategic planning horizon." — Provide critical challenge of management's assessments and recommendations. — Assign accountability for climate-related financial risks within existing organizational structures (risk management, internal audit) or establish new structures for climate-related financial risks. **Management responsibilities:** Implement policies at the board's strategic direction and execute the strategic plan and risk management framework. — Assure sufficient expertise to execute the strategic plan and manage all risks, including climate risks. — Develop and implement processes to identify, measure, monitor, and control climate-related financial risks within the existing risk management framework. — Hold staff accountable for controlling risks within established lines of authority and responsibility. — Provide regular reporting to the board on level/nature of risks, including material climate risks.

2. Policies, Procedures, and Limits	— Incorporate material climate-related financial risks into policies, procedures, and limits to provide guidance on approaching these risks in line with the strategy and risk appetite set by the board. — Modify policies and procedures, as needed, to reflect the distinctive characteristics of climate-related financial risks and changes in the financial institution's operating environment or activities.
3. Strategic Planning	— Consider climate-related risks while setting and monitoring the overall business strategy, capital plans, and risk appetite of the financial institution. — Assess potential impacts on financial condition, operations (including geographic locations), and business objectives. — Examine how climate risks may affect other operational and legal risks. — Consider the impact that mitigation strategies may have on LMI and underserved communities. — Assure (board and management) that public statements about climate-related strategies and commitments are consistent with internal strategies, risk appetite statements, and risk management frameworks.
4. Risk Management	— Incorporate climate-related risks into existing risk management frameworks. — Develop processes to identify, measure, monitor, and control exposures. — Obtain input from stakeholders from across the organization (e.g., business units, independent risk management, internal audit, legal) — Leverage tools such as heat maps, scenario analysis, and dashboards.
5. Data, Risk Measurement, and Reporting	— Incorporate climate-related financial risks into internal reporting, monitoring, and escalation processes to facilitate timely, accurate, and relevant data and sound decision-making. — Segregate and report exposures by physical and transition risks. — Monitor developments in data, tools, modeling, and reporting and incorporate as warranted.
6. Scenario Analysis	— Emphasize a forward-looking assessment of potential impacts resulting from climate risks. — Develop frameworks depending on the institution's size, complexity, and risk profile. — Explore impacts on strategy, vulnerability, and loss estimations; include extreme but plausible scenarios. — Report results "clearly and regularly" to the board and "all relevant individuals."

Management of Risk Areas.

Risk Area	Description
Credit Risk	— Incorporate climate-related risks in underwriting and ongoing monitoring of portfolios. — Monitor sectoral, geographical, and single-name credit risk concentrations. — Determine credit risk tolerances and lending limits related to material climate risks.
Liquidity Risk	— Assess if climate-related risks impact the financial institution's liquidity and incorporate them into liquidity risk management practices and buffers.
Other Financial Risks	— Monitor interest rate, price, and other risks for increased volatility or unpredictability due to climate-related financial risks.
Operational Risk	— Evaluate the impact of climate-related risks on operations, control environment, and operational resilience (assess across all business lines and operations, and operations by third parties). — Consider business continuity and evolving legal and regulatory landscape.
Legal and Compliance Risk	— Assess changes in legal and regulatory landscape due to climate-related risks and risk mitigation measures. — Examine potential for discriminatory impacts from risk mitigation measures.
Other Nonfinancial Risks	— Monitor how strategy execution and operating environment affect financial condition and operational resilience due to climate-related risks.

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