

Comments on the Financial Stability Board's proposed *Supervisory and Regulatory Approaches to Climate-related Risks*

Submitted by Public Citizen, a US public interest advocacy group

On behalf of Public Citizen, a US public interest advocacy group, and its more than 500,000 members and supporters, we welcome the opportunity to comment on the Financial Stability Board's (FSB's) interim report, *Supervisory and Regulatory Approaches to Climate-related Risks*. Promoting coordinated and consistent global action on microprudential and macroprudential climate-related financial risks is critically important to maintaining financial system health and avoiding disproportionate impacts to vulnerable jurisdictions and communities.

We strongly support the FSB report's overarching message that while supervisory and regulatory action in response to the unique features of climate risk is progressing, more remains to be done. We also agree with many of the more specific observations and recommendations, including the following: (1) climate change is a global concern that requires not only microprudential but also macroprudential responses; (2) several jurisdictions are showing a path to action — demonstrating the feasibility of important micro- and macroprudential responses, including those related to data, scenario analysis, concentration limits, capital requirements and systemic risk buffers, among others — and other jurisdictions should follow suit; (3) risk management measures can disproportionately impact the most vulnerable; and (4) new measures are needed, particularly in response to evolving understandings of climate risk.

Nevertheless, the draft report could be strengthened in several important ways, including by: (1) clarifying that the call to action must be underpinned by a precautionary approach; (2) encouraging more robust testing of scenario analysis models; (3) recognizing that risks related to climate change are not only novel, but also materializing now and with significant impact to individual communities and the local financial entities that serve them; (4) acknowledging and addressing the reality that the root causes of this risk, including activities that facilitate greenhouse gas emissions, are continuing unabated through actions by financial entities to finance and underwrite those activities; and (5) recognizing that novel climate risk features, as well as increasing risks and

impacts, point to a need to evolve regulators' understanding of the financial system - including their understanding of interconnectedness, which entities are important to the financial system, systemic risk, and risk management measures.

The FSB report advances many useful observations and recommendations that should compel action by regulatory authorities, including in the US.

One useful aspect of the FSB report is its description of the state of play of regulatory action. It reflects that some jurisdictions are taking relatively nascent action on supervisory review, information disclosure, and microprudential concerns. This description characterizes US regulatory efforts to date; banking regulators are advancing supervisory guidance targeting microprudential risks to large banks, the securities regulator has proposed to increase climate risk-related disclosures - including of Scope 3 emissions, but with unwarranted deference to corporate determinations of materiality - and insurance regulation is occurring on a piecemeal basis at the state level.

The report also provides promising examples of how a few other jurisdictions are beginning to address macroprudential concerns. In this regard, the report invites a more expansive view of climate risk-related concerns and of needed actions - a view that is welcome given that US regulators have not yet addressed macroprudential concerns or the need to regulate financed emissions. As the FSB report notes, other jurisdictions such as the EU and UK are beginning to more fully address Scope 3 emissions, concentration limits, capital requirements, and systemic risk buffers. Public Citizen has urged the [Office of the Comptroller of the Currency](#), the [Federal Deposit Insurance Corporation](#), and the [Securities Exchange Commission](#) to pursue such measures. In providing the contrast between jurisdictions, the FSB report should provide an important prompt to action.

The FSB should embrace a precautionary approach to regulation.

The report usefully acknowledges the significance of threats posed by climate change to the financial system and the need for greater data and scenario analysis at both micro and macro levels. However, it should also recognize that identified limitations of data and scenario analysis should not impede action. Precise data needed to predict the specific timing, significance and location of climate change-related impacts are limited given the inherent uncertainties of climate change. And climate change will continue to worsen and generate new and unpredictable risks that may be correlated across previously unrelated asset classes. As climate data is imprecise, so too is scenario analysis relying on these data. As the [US White House](#), the [Intergovernmental Panel on](#)

Climate Change, and others have noted, given these limitations, a precautionary approach to managing climate risk is necessary.

A precautionary approach means prioritizing reducing risk even where there is not full certainty about its magnitude or probability and in the absence of perfect scientific or economic data. Implementing this approach could mean taking on less risk than what models suggest is acceptable, on the assumption that those models do not accurately quantify the likelihood or magnitude of all relevant risk factors, and showing greater sensitivity to high-magnitude risks even when models suggest they are remote. This latter strategy is particularly apt in the climate context. Climate models themselves under-forecast harms, largely because significant aspects of climate change cannot be precisely modeled yet. The science is being updated constantly, and most updates darken the outlook. Additionally, when developing risk management procedures, a precautionary approach entails not just avoiding unacceptable harms, but also planning for resilience to inevitable failures. Such an approach counsels financial institutions to assume every part of the business is subject to climate risk, even in seemingly implausible lines of business. Global warming is still increasing and, even if it wasn't, scientific knowledge is still developing.

A precautionary approach would also recognize the importance of regulators taking a more active role in reducing the risk that the financial system faces. As Public Citizen has [noted](#), financial regulators in applying a precautionary approach would “begin shepherding the financial system toward the clean-energy transition—carefully letting the air out of asset bubbles that otherwise might burst spectacularly and mitigating the systemic risk that financial institutions create when they finance activities that are grossly misaligned with science-based climate targets.”

The report should encourage robust testing of scenario analysis models.

Another important response to data limitations is to require careful testing of scenario analysis models that are employed using those data. One approach, for example, includes ‘backtesting’ of scenario analysis models, similar to the use of [backtesting in other contexts](#). Backtesting involves determining the extent to which a model accurately predicts events that have already occurred, to evaluate the robustness of the model and its assumptions. If backtesting reveals a wide gap between expectations and reality, the model is less likely to predict future scenarios accurately. If scenario analysis models cannot accurately predict the last few years of climate impacts based on historical data, then banks and regulators should not rely on their determinations that banks will be robust and resilient to future climate risks. To the contrary, if models perform poorly on backtesting exercises, that is all the more reason to adopt a precautionary approach.

The report should recognize not only the novel features of climate risk, but also that this risk is materializing now and requiring risk management measures that target financed emissions.

The report importantly recognizes that climate risk includes novel features that have systemic implications - including “risk transfers between financial sectors, spillovers and feedback loops between the financial system and the real economy”¹ - and require macroprudential responses. It provides examples of financial concerns that could be produced via these novel features, including a “potential increase in premia and insurance protection gaps,” among other impacts.

The report could be strengthened by adding the following related information: (1) novel features are *already* producing the described financial concerns; (2) climate risks are already materializing as a result of these financial concerns; (3) these materializing risks are pointing to possible subsystemic harms in addition to systemic harm; and (4) risk management measures that reduce financed emissions are needed.

For example, links between financial sectors, as well as feedback loops between the financial system and real economy, are already occurring, with significant impacts to marginalized communities in vulnerable areas in the US as well as globally. In Louisiana, the Insurance Commissioner recently announced that the state-run insurance corporation is assuming coverage for 13,000 individuals as nearly one dozen private companies depart climate hotspot areas. Louisiana taxpayers, through public-sector entities, are now at least temporarily helping to moderate credit risks faced by banks and other financiers in these areas. It is not clear how long this taxpayer support can continue. As described in a [2020 report by an advisory committee to the Commodity Futures Trading Commission](#), these “subsystemic risks” could accumulate to systemic risks and reflect a slow-motion systemic crisis.

These impacts on the real economy are a function of more frequent and significant weather-related events, and they are evidence that the health of financial systems is linked to that of environmental systems. Future impacts to the real economy and financial system might be reduced by additional resilience and adaptation measures,

¹ The draft states, “Authorities are starting to expand their approaches by looking at risks in aggregate and factoring in system-wide aspects such as risk transfers between financial sectors, spillovers and feedback loops between the financial system and the real economy. Examples include the potential increase in insurance premia and insurance protection gap which could impact credit risk for banks; credit tightening and financial stress resulting from abrupt changes in global climate policy; potential fire-sale dynamics; and the potential for risk management actions by individual financial institutions to cumulate to create systemic risks. This work would in turn help inform policy approaches or supervisory expectations to avoid unintended consequences and a less effective transition.” p.3

but the most efficient and effective approach to avoiding them is to tackle their root causes — to reduce greenhouse gas (GHG) emissions, including through reduced financing and underwriting of GHG activities.

The FSB document should acknowledge the threats posed to the financial system by these financing activities and explicitly recognize that measures to reduce financed emissions are critically important risk management measures firmly within the remit of regulators concerned with the safety and soundness of banks and with the stability of the financial system.

The report should acknowledge that disproportionate impacts to marginalized communities underscore the need for regulators to address issues of responsibility for risks, harms, and responses.

The report provides some recognition that disadvantaged communities will be disproportionately impacted by climate change. It observes that measures to address climate risk could introduce “tradeoffs,” and notes that one such tradeoff could involve restrictions “in lending to the most disadvantaged communities if those communities are located in climate-vulnerable areas.”²

The report, however, does not paint the full picture of impacts to disadvantaged communities, what these impacts might mean for the financial system, and how they raise issues of responsibility for risks and impacts.

The report should recognize that disadvantaged communities are not only disproportionately located in climate vulnerable areas but also have less capacity to avoid and respond to impacts. In the US, these communities’ access to credit is already being challenged through bank consolidation and threats to community banks and [credit unions](#). Through these events and those noted above, climate change is already disproportionately impacting these communities, and these impacts have implications for links between financial sectors and feedback loops between the real economy and financial system.

These impacts to local communities spotlight issues of responsibility. Marginalized communities should not bear full responsibility for costs related to risks they didn’t willingly assume. Regulators should require entities facilitating these risks, including entities financing and underwriting greenhouse gas (GHG) emitting activities, to minimize the risks and costs they impose on these communities. The draft should acknowledge these concerns, and indicate the need for financial institutions to reduce

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their financed emissions, finance resilience in communities they serve, and otherwise help mitigate the impacts of climate-related risk on these communities.

The report should indicate that novel features of climate risk should compel regulators to treat natural systems and local entities as more interconnected with, and important to, the financial system.

New understandings of climate-related risk should point to the need for risk management measures that recognize the importance of protecting aspects of the natural environment, including baseline environmental conditions and stability, to protecting the financial system, and should recognize the importance of local private and public sector entities to financial system resilience.

As mentioned above, in the context of climate risk, interconnectedness relates not only to connected balance sheets but also to connections between the financial and environmental systems. Although it is not the job of banking regulators to protect natural systems, it is well within their job to prevent banks from contributing to a disruption of natural systems so severe that it undermines financial stability.

Additionally, observations about new feedback loops between the financial system and real economy suggest that financial regulators should be more attentive to the importance of local entities. In the US, for example, community banks are important sources of credit for local community efforts to build resilience and respond to the impacts of climate change. To the extent that climate harms have important implications for financial stability, the health of institutions that finance climate-related mitigation, adaptation, and resilience are similarly important. As the Louisiana example above indicates, public-sector entities are also important to the health of the real economy, as they provide critical services to individuals and the private sector and otherwise support their resilience and adaptability to climate change. These entities are more vulnerable to climate change than larger, private actors, as they face constraints moving to other areas or shifting activities to avoid climate change-related harm.

We appreciate the opportunity to comment on this FSB proposal. For more information, please contact Anne Perrault, aperrault@citizen.org and Yevgeny Shrago, yshrago@citizen.org