Climate Change Risks and Maryland Financial Institutions

Office of the Commissioner of Financial Regulation

April 25 and April 27, 2023

Maryland
DEPARTMENT OF LABOR

Introduction and
Purpose of Today's Presentation

To provide guidance to the board of directors and management of Maryland chartered financial institutions about the Commissioner's current expectations regarding the **management of the various risks posed by climate change** and on the **establishment of governance structures** to manage those risks.

- Tony Salazar, Commissioner of Financial Regulation

Presentation Topics

- ✓ Background
- ✓ Physical and Transition Risks
- ✓ Federal and State Agency Actions
- ✓ Looking Down the Road
- ✓ Discussion with Commissioner Salazar

Weather Vs. Climate

Weather **and** ***climate*** **are not synonymous.**

Weather

- Is short-term
- Limited to a set area
- Can change rapidly
- Can be difficult to predict

Climate

- Is long term (average of years of weather observation)
- Covers a large area
- Is seasonal
- Is measured over a long span of time

Climate Risk Defined

Climate risk is the potential for climate change to create adverse consequences for human or ecological systems.

This includes impacts on lives, livelihoods, health and wellbeing, economic, social and cultural assets and investments, infrastructure, provision of services, ecosystems and species.

Background

Climate change risks are inherent in all institutions regulated by OCFR.

- Depository Institutions
- Non-Depository Companies

There are many aspects to climate change risk, but two primary risk drivers are:

- Physical Risk
- Transition Risk

Physical Risk

Physical risk refers to the impact on assets from acute changes to climate (e.g., storm severity, floods, droughts) or chronic climate changes (e.g., susceptibility to increased flooding or drought risk, population matriculation from impacted areas).

Physical Risk Manifestations

Physical risk manifestations in the short term include:

- Loss of or damage to collateral
- Disruption to the business of a financial institutions' customers
- Disruption to or loss of a financial institution's own assets, such as branches, ATMs, servers or property holding
- Disruption to operations

Longer term manifestations are seen as the impact from chronic climate change (e.g., changes in climate physically and permanently impacting a property or region such as susceptibility to increased flooding or drought risk and the impacts on local economies resulting from those long-term changes).

Transition Risks

Transition risk refers to stresses that financial institutions or sectors may face arising from the shifts in policy, consumer and business sentiment, or technologies associated with the changes deemed necessary to limit climate change.

- Policy initiatives taken in the context of climate change (e.g., carbon tax, California/New York policies of only Electric Vehicles (EVs) by 2035; national subsidization of EV charging stations; grid renewable energy requirements)
- Technological change (e.g., carbon capture and storage; alternative energy; nuclear fusion)
- Investor sentiment (stakeholder capitalism; Environmental, Social, and Governance (ESG) rules and ratings)
- Consumer sentiment (economic support of climate friendly entities; boycotts; greenwashing impact)

At-Risk Assets

At-risk assets include:

- Loans, loan collateral, bonds, securities, derivative contracts
- The continuity of borrowers and your institution’s business partners, including their goodwill/reputation and ability to continue as ongoing business concerns and their physical assets
- Your institution’s own assets including its facilities, specialized subsidiaries, contractual relationships, labor force, goodwill/reputation, strategic goals

Examples of Climate Change Reactions that Raise Transition Risks:

- Adoption of complex policy changes to reach zero emissions
- Adoption of climate-related regulations
- Tax code changes
- Revocation of explicit and implied subsidies for fossil fuel companies
- Government direct/indirect investment in low carbon emitting infrastructures
- Changes in consumer and/or market sentiment
- Development of new or advanced technologies or processes
- Adoption of new technology or processes
- Scientific discoveries

Potential Impacts

Thoughts to consider on potential impacts of climate change on financial institutions:

- How might climate impact the capital base of businesses or reduce their profitability?
- How can financial institutions monitor or evaluate the impact of affected businesses on their own capital base and profitability?
- How can transitional risks lead to reputational damage to customers or the financial institution itself?
- What types of portfolio changes or restructuring should be considered based on potential climate change impacts?
- How could financial institutions' strategic plans or planning processes be impacted by potential climate change impacts on the institution's business model?

Federal and State Actions

Federal Reserve

- Circulated draft principles on a high-level framework regarding the safe and sound management of climate related financial risk
- Stated it is not going to be involved in policy on climate change
  - Climate policy making is not the Federal Reserve's job
  - Federal Reserve will stick to its core competencies and statutory goals to maintain its independence.

Federal Deposit Insurance Corp. (FDIC)

- Circulated draft principles on a high-level framework regarding the safe and sound management of climate related financial risk
- Publicly identified climate change as a risk in 2022 and stated that addressing those risks will be an agency priority in coming years

Federal and State Actions (cont.)

National Credit Union Administration (NCUA)

Publicly identified climate change as a risk in its 2022-2026 Strategic Plan:

- “Credit unions need to consider climate-related financial risks, and how they could affect their membership and institutional performance”
- “The NCUA will not micromanage any lending for climate financial risk. This includes lending to family farms and others in the agricultural sector, as well as businesses tied to the fossil fuel industry.”

Securities and Exchange Commission (SEC)

Focused on ensuring “consistency and comparability” so that investors can make informed decisions, it will be “merit neutral” when it comes to how investors should incorporate greenhouse gas emissions into their investment strategy.

Federal and State Actions (cont.)

Commodity Futures Trading Commission (CFTC)

Will wait for explicit congressional authorization before pursuing direct climate regulation

NY Department of Financial Services (DFS)

DFS has been a leader in addressing climate change risk.

- Started addressing the issue in 2020. Most recently it issued a draft guidance document and comment period ended 3/1/23.
- Guidance applies to state-chartered institutions and is intended to set expectations and to support industry compliance efforts

Other Government Actions

What Governments are Doing About Climate Change:

- The federal government is moving to redirect the American economy away from fossil fuels
- The Environmental Protection Agency (EPA) is a leader but other agencies also including climate change response into their agendas
- The Maryland General Assembly has passed and is considering new laws to align Maryland policies with those of the federal government
- Governor Moore announced Maryland's participation in the U.S. Climate Alliance and is committed to supporting efforts to achieve the Paris Agreement’s temperature limiting goals
- Other States have taken active steps to block firms perceived as not supporting the State’s environmental policies from receiving state benefits or participating in state programs
- Globally, many countries are also moving aggressively targets to reduce greenhouse gas emissions by 40% before 2030.

OCFR Climate Change Status

- OCFR acknowledges that climate change is an important issue but recognizes that environmental policy is not a core competency nor is it a part of OCFR's mandate.
- OCFR's approach is guided by four key themes: 1) agency coordination, 2) risk-focus, 3) tailored approach, and 4) climate-related financial risk tool creation or identification and distribution.
- OCFR has worked, and continues to work with other state regulators, to better understand the relevant issues and risks, to coordinate state regulatory response, and to develop tools for financial institutions and regulators to use as they navigate this area.
- OCFR will continue to stay active and as it believes that climate change supervisory principles should balance supporting the safety and soundness of financial institutions with the costs and benefits of any new expectations, particularly to ensure that there is a level playing field for all participants in the financial services industry in Maryland.

OCFR Expectations

- OCFR expects board of directors and management at a minimum to start learning about these issues.
- Boards and management should commence discussing the macro issues related to management of the financial risks of the various aspects of climate change affecting the market.
- Boards and management should begin now to consider how climate change issues will affect their institution.

Looking Down the Road – What We See for Financial Institutions

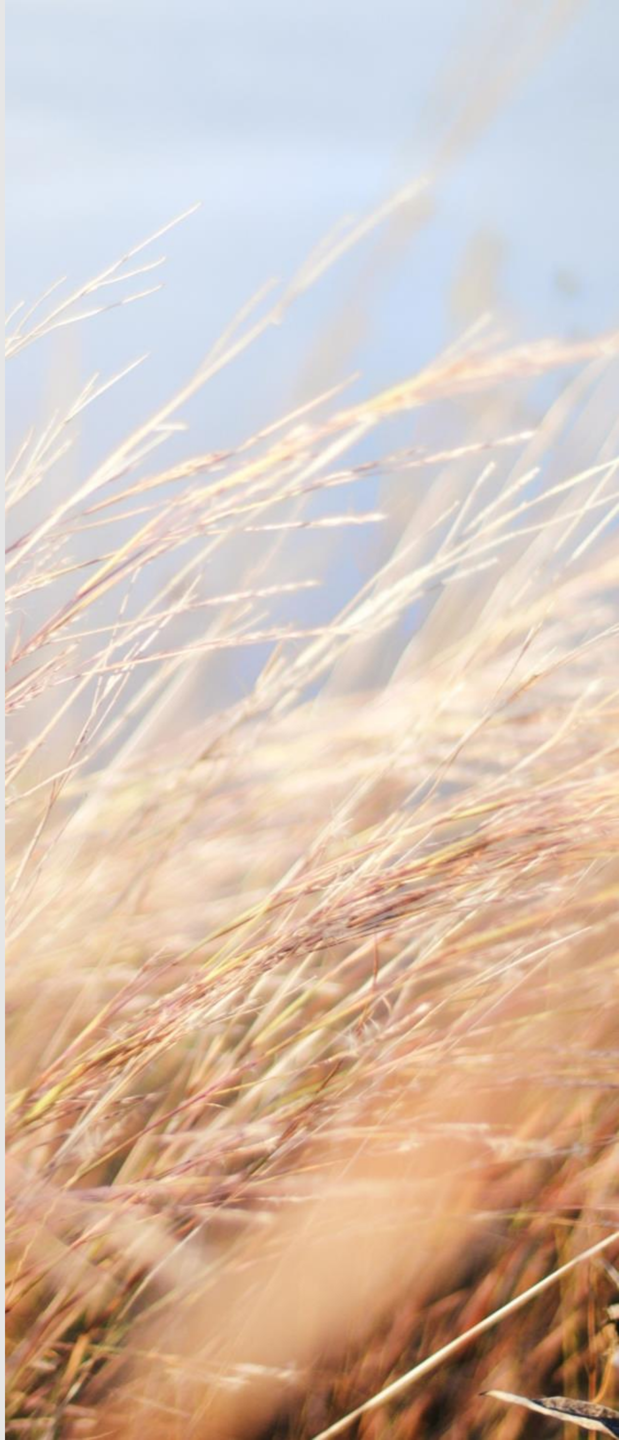
- Identify climate-related physical and transition risks
- Continuously engage with external and internal resources to improve data and modeling
- Use a consistent and comparable set of data-driven scenarios for modeling
- Adopt and continuously improve key risk indicators to monitor each of these risks and their potential impact on capital, earnings, liquidity, and operations
- Conduct quantitative climate-related risk analysis to size each in comparison to relevant performance metrics
- Integrate climate-related risks into risk management processes
- Consider risk management and investment decisions, and embed them into strategic planning

Other Potential Practices and Governance

- Integrate sustainability factors into your own-portfolio management.
- Integrate sustainability factors into the management of your own operations
- Look to central banks and other large financial institutions that may lead by example in their own operations

Topics for Initial Discussion

- Institutional leadership and oversight
- Understand nature of potential physical risks to institution’s/customers’ assets and operations
- Understand nature of potential transitional risks
- Begin discussion of how to incorporate climate risk into risk assessment processes
- Begin discussions on potential due diligence needs
- Identifying potential climate risk modeling or rating tools and data needs
- Understand potential risk transfer mechanisms or tools
- Potential opportunities



Office of the Commissioner of Financial Regulation

CONTACT

Emmanuel U. Mgboji; MBA, PhD.
Financial Depository Examiner Supervisor
emmanuel.mgboji@maryland.gov

OCFR WEBSITE

www.labor.maryland.gov/finance

MAIN PHONE NUMBER

(410) 230-6100

GENERAL E-MAIL

DLFRFinReg-LABOR@maryland.gov

OFFICE ADDRESS

1100 North Eutaw Street, Suite 611
Baltimore, Maryland 21201

Maryland
DEPARTMENT OF LABOR

Wes Moore, Governor
Aruna Miller, Lt. Governor
Portia Wu, Secretary, Maryland Department of Labor
Antonio P. Salazar, Commissioner of Financial Regulation

Discussion with Commissioner Salazar

1) What are your views on the financial risk impact of climate change to your institution?

2) What climate-related risks has your management raised in discussions with your counterparts, regulators or through public information channels?

3) What kind of climate-related financial risks disclosures (if any) do financial institutions in your local business area make such as governance, strategy, risk management, and/or metrics and targets?

4) What specific challenges or barriers do you envision preventing your institution from actively analyzing climate-related risks and, if necessary, taking responsive steps?

5) Has your institution implemented any climate risk related responses that are specifically incorporated into your institution's day-to-day operations?