

Climate Change Financial Risk Act of 2021

Climate change is increasing the frequency and severity of extreme weather events like floods and wildfires. It is also changing long-term climate patterns in ways that will lower labor productivity, devalue and destroy assets, stress agricultural yields, and ultimately affect every sector of our economy. These economic impacts pose risks for financial firms and the global financial system.

Financial institutions face the risk of direct losses from severe weather events and fundamental changes like drought and sea level rise—for example, lower property values from increased flooding. They also face risks from market volatility, an erosion of investor confidence, and changes in carbon-intensive asset values resulting from government policies and consumer preferences.

Even though quantifying and managing these risks falls squarely within its mandate, the Federal Reserve (“the Fed”) is not yet accounting for climate risks in its stress tests—unlike its counterparts in the United Kingdom,¹ France,² the broader Eurozone,³ and other jurisdictions.⁴ The *Climate Change Financial Risk Act* will change that by mandating stress tests for large financial institutions to measure their resilience to climate-related risks.

Bill Summary:

- The bill establishes an advisory group of climate scientists and climate economists to help develop climate change scenarios for the financial stress tests.
- With input from the advisory group and federal scientific agencies, the Fed will create three stress test scenarios: a 1.5 degree Celsius warming scenario; a 2 degree scenario; and a “business as usual” scenario, which assumes a higher level of warming if there are no climate policies in place.
- For each scenario, the Fed will quantify the ways in which climate-related physical and transition risks could disrupt the economy and global business operations.
- Based on these scenarios, the Fed will conduct nonbinding stress tests every two years on the same large financial institutions that are currently subject to Comprehensive Capital Analysis and Review (CCAR) stress tests—*i.e.*, financial firms with more than \$250 billion in total consolidated assets (and some with assets over \$100 billion, if the Fed deems it necessary to promote financial stability).
- The biennial tests will require each covered institution to create and update a remediation plan, which will describe how the institution plans to evolve its capital planning, balance sheet and off-balance sheet exposures, and other business operations to respond to the most recent test results.
 - Fed objections to a remediation plan would limit the institution’s ability to proceed with capital distributions until it improves its plan. However, institutions would not have to increase their current capital based on the results of a climate stress test.
- Based on the same scenarios used for the stress tests, the Fed will partner with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation to design a nonbinding exploratory survey, which will assess the ability of sub-systemic banks (those with more than \$10 billion in assets) to withstand climate risks.
 - The Fed will administer the survey every two years and report on the results in aggregate. Survey participants will remain anonymous in the report and will not face adverse consequences on the basis of their responses.
- The bill also creates a climate change risk committee within the Financial Stability Oversight Council, charged with assessing and reporting annually on climate-related risks to the U.S. financial system.

¹ <https://www.bankofengland.co.uk/paper/2019/biennial-exploratory-scenario-climate-change-discussion-paper>

² <https://www.reuters.com/business/sustainable-business/french-banks-told-speed-up-response-climate-change-2021-05-04/>

³ <https://www.ecb.europa.eu/press/blog/date/2021/html/ecb.blog210318~3bbc68ffc5.en.html>

⁴ <https://www.fitchratings.com/research/banks/climate-change-stress-tests-are-becoming-mainstream-15-03-2021>