The OCC's Proposed Principles for Climate Risk Management by Large Banks:

Ten Things To Know

On December 16, 2021, the Office of the Comptroller of the Currency ("OCC") issued draft principles (the "Proposal") on the identification and management of climate-related financial risks by OCC-supervised banks with more than $100 billion in total consolidated assets ("covered banks"). The Proposal is intended to provide a high-level framework for the safe and sound management of climate-related financial risks by covered banks and will serve as the basis for more detailed guidance applicable to all OCC-supervised banks. Feedback on the Proposal is due by February 14, 2022; the OCC has indicated that subsequent guidance will incorporate the feedback received on the Proposal and distinguish the roles and responsibilities of boards of directors and management.

1 The Proposal represents a significant step in the federal banking agencies' increasing focus on climate-related financial risk.

Management of climate risks is rapidly becoming a core priority for the federal banking agencies. The Proposal follows the report issued by the Financial Stability Oversight Council ("FSOC") on October 21, 2021, pursuant to an Executive Order issued by President Biden in May 2021, recommending that its member agencies pursue a range of actions to integrate climate-related financial risk into their regulatory and supervisory activities ("FSOC Report"). (Our client alert summarizing the FSOC Report is available here.) The federal banking agencies are devoting substantial resources to advancing the priorities discussed in the FSOC Report, including with respect to scenario analysis, risk management guidance, and data collection and reporting.

2 The other federal banking agencies did not join the OCC in issuing the Proposal, and it is unclear whether those agencies will align around a consistent interagency approach to climate-related financial risk.

Notwithstanding the fact that Acting Comptroller Hsu stated in September 2021 that the OCC was working with the other federal banking agencies to develop climate risk management guidance, and that Board of Governors of the Federal Reserve System ("Federal Reserve") Governor Brainard suggested in October 2021 that the Federal Reserve's Supervision Climate Committee was engaging with domestic stakeholders and other supervisors in part to develop climate risk guidance for large banking organizations, neither the Federal Reserve nor the Federal Deposit Insurance Corporation ("FDIC") joined the OCC in publishing this Proposal. Thus, while we expect that the other federal banking agencies will follow suit in issuing similar guidance, it is not clear whether the OCC's individual action suggests that the agencies' ultimate approach to this topic may not be uniform.

3 Although the Proposal emphasizes that each covered bank should develop climate risk management practices commensurate to its size, complexity, and other factors, the application of certain of the Proposal's framework elements—and mandatory scenario analysis in particular—to all OCC-supervised banks with at least $100 billion in total consolidated assets would be a significant development.

While the Proposal states in several places that the OCC intends to apply its supervisory expectations for climate risk management based on each covered bank's circumstances, such as complexity of operations and business models, many of its key elements, even if tailored, would represent a significant expansion of supervisory expectations for certain covered banks. In particular, the requirement that covered banks with less than $250 billion in total consolidated assets must implement scenario analysis programs for climate-related risks would represent a considerable burden. Moreover, this scenario analysis requirement would represent a major divergence from the approach taken under the interagency enhanced prudential standards framework, under which such banks are not subject to company-run stress testing requirements, as directed by section 401 of the Economic Growth, Regulatory Relief, and Consumer Protection Act.

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4 The Proposal generally would prescribe a range of specific elements of banks' risk management frameworks for climate-related financial risk, including with respect to governance, risk management, and scenario analysis, but appears to leave banks with considerable flexibility in how these elements are implemented.

The Proposal provides high-level principles for the management of climate-related financial risk, rather than detailed supervisory expectations. Nonetheless, if adopted substantially as proposed, the Proposal would impose significant supervisory expectations for covered banks and identify a number of specific programmatic elements that the OCC would expect covered banks to incorporate into their risk management frameworks.

- ***Governance.*** The Proposal states that effective risk governance is essential to the safe and sound management of exposure to climate risk. For example, the Proposal would note that the board of directors and management should have an appropriate understanding of these risk exposures, including an understanding of how they may evolve over various scenarios across relevant time horizons—even if these time horizons extend beyond the bank's typical strategic planning horizon. Importantly, the Proposal would not mandate any particular governance structure to meet these expectations. Instead, the Proposal would require that responsibilities and organizational structures be clearly delineated.

- ***Risk management***. The Proposal also would state that bank management should employ a comprehensive process to identify climate-related risks—which should include input from stakeholders across the organization with relevant expertise, including business units and independent risk management—and to incorporate these risks into internal control frameworks such as internal audit. The Proposal would not, however, specifically reference the three lines of defense model, suggesting that it would not prescribe or favor any particular approach to risk management.

- ***Scenario analysis***. The Proposal describes scenario analysis as an important tool for identifying, measuring, and managing climate-related risks, and accordingly that management should develop scenario analysis frameworks with objectives that support the climate risk management strategies of the bank. The Proposal itself would not prescribe these objectives, but would require that these objectives be clearly defined. At the same time, the Proposal would emphasize that covered banks should develop rigorous scenario analysis frameworks that are subject to appropriate quality control.

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5 The Proposal incorporates climate risk into existing risk types, rather than treat climate risk as an independent risk type.

The Proposal defines climate-related financial risk as the physical and transition risks associated with climate change and explains how these risks may manifest as various financial and non-financial risk types, such as credit, liquidity, operational, and legal/compliance risks. This approach, which aligns with the treatment of risk management in the FSOC Report, suggests that the federal banking agencies will continue to view climate-related financial risk as a cross-cutting risk that may arise within traditional risk types, not as an entirely new risk type. This approach also explains why the Proposal describes climate-related financial risk as an element of the bank's overall risk appetite, rather than as a separate risk appetite that covered banks must establish and monitor.

6 The Proposal would require that covered banks develop climate-related risk limits and key performance indicators.

The Proposal specifically would require covered banks to develop appropriate metrics to support climate risk management, including risk limits and key performance indicators ("KPIs"), and would require these metrics to be incorporated into policies and procedures. It would not, however, prescribe any particular limits, KPIs, or other metrics that must be used.

7 The Proposal acknowledges the limitations and nascent state of climate-related risk management capabilities in a number of areas.

Like the FSOC Report, the Proposal expressly recognizes that data gaps and other limitations on risk measurement, modeling methodologies, and reporting capabilities exist at this time but are developing at a rapid pace. The Proposal therefore would require covered banks to monitor these developments and to incorporate climate-related financial risks into various strategic planning processes and data, risk management, and reporting activities in an iterative manner over time.

8 The Proposal generally would not address disclosure, but would caution against inaccurate climate-related public statements that are not consistent with covered banks' internal strategies and risk appetite statements.

With the exception of one question for comment, the Proposal focuses on internal reporting processes and does not address how the OCC may use its reporting and data collection powers to assess bank risk management capabilities, nor does it reference the U.S. Securities and Exchange Commission's ongoing work to develop climate disclosure requirements for public issuers that would promote disclosures for investors regarding climate-related risks and opportunities. However, the Proposal would require boards of directors and management to ensure that public statements about their banks' climate-related strategies and commitments are consistent with internal strategies and risk appetite statements. This suggests that the OCC may actively supervise covered banks' public statements for "greenwashing" or similar concerns, and underscores the importance of covered banks giving careful consideration to climate-related pledges and commitments.

9 The Proposal emphasizes the impact of climate-related financial risk on low- to moderate-income and other disadvantaged communities.

Like the FSOC Report, the Proposal observes that the impacts of climate-related financial risk could fall disproportionately on financially disadvantaged communities. The Proposal therefore would require covered banks to specifically consider how to mitigate the impact of climate-related financial risk on disadvantaged communities, including with respect to physical harm and loss of access to bank products and services. This framing may suggest that the OCC, Federal Reserve, and FDIC are increasingly likely to incorporate climate-related measures into their anticipated rulemaking to substantially revise the Community Reinvestment Act assessment framework.

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10 The Proposal broadly aligns with developing international climate risk management frameworks.

On November 16, 2021, the Basel Committee on Banking Supervision's Task Force on Climate-related Financial Risks ("TCFR") issued a consultative document entitled "Principles for the effective management and supervision of climate-related financial risks." Comments on this document are due by February 16, 2022, just two days after the deadline for comments on the Proposal. The Proposal and TCFR consultative document both emphasize topics such as governance, risk management, internal control frameworks, scenario analysis, and data and reporting, and the documents employ identical language in certain instances. In the interest of promoting consistent supervisory standards, particularly for covered banks with global operations, it will be important for the OCC and TCFR to harmonize their expectations to the greatest extent possible.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our Financial Services practice:

Randy Benjenk	+1 202 662 5041	rbenjenk@cov.com
Jeremy Newell	+1 212 841 1296	jnewell@cov.com
Michael Nonaka	+1 202 662 5727	mnonaka@cov.com
Karen Solomon	+1 202 662 5489	ksolomon@cov.com
Andrew Ruben	+1 212 841 1032	aruben@cov.com