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New York Department of Financial Services calls on financial institutions to consider climate change risk

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In a recent letter, the New York State Department of Financial Services (NYDFS) called on state-regulated financial institutions to integrate climate-related financial risks into their governance frameworks, risk management processes, and business strategies.

> Climate-change related risks range from the increased threat of inclement weather to physical assets and supply chains, to the potential for fossil-fuel assets to become "stranded" in the transition to a renewable energy economy.

Investors increasingly view climate as an area of business risk, and this confirms regulators are beginning to view it as a supervisory risk as well. Incorporating climate change risk analysis can help financial institutions to better understand risks to their portfolios and clients, and to meet regulatory expectations.

Now, with NYDFS announcing its "expectation" that institutions within its purview account for climate change in their risk assessments, New York has signaled a new approach in its efforts to combat climate change.

THE NYDFS LETTER

On October 29, 2020, the NYDFS published a letter[1] to the state's banks and regulated non-depository institutions explaining what NYDFS sees as the principal financial risks stemming from climate change.

The letter calls on financial institutions regulated by the state to work to incorporate climate-related financial risks into their governance, strategy, and risk management. The NYDFS letter highlights both the physical and the transitional risks of climate change facing financial institutions.

These risks range from the increased threat of inclement weather to physical assets (both the institution's proprietary assets and assets securing outstanding loans) and supply chains, to the potential for fossil-fuel assets to become "stranded" in the transition to a renewable energy economy.

To address these risks, the letter urges financial institutions to implement specific business practices and governance reforms. For instance, NYDFS suggests that banks designate a board member or committee, as well as a senior management function, to be accountable for assessing and managing climate-related risks.

Similarly, NYDFS expects regulated non-depositories to assess how the direct and indirect risks of climate change could affect their balance sheets and to identify steps to mitigate those risks.

Because financial institutions are affected by climate change in different ways and have varying levels of resources, NYDFS advises that "each organization should take a proportionate approach that reflects its exposure to the financial risks from climate change and the nature, scale, and complexity of its business."

> State pension funds like CalPERS in California and the New York State Common Retirement Fund have also voluntarily adopted rules requiring consideration of ESG factors in their investment decisions.

While the letter makes no specific mention of penalties or other enforcement tools, New York state-regulated institutions should be prepared for NYDFS examiners to inquire as to the institution's actions and approaches in connection with climate change risk.

NEW YORK'S VOICE IN A GROWING CHOIR

While the NYDFS letter primarily focuses on the identification and mitigation of risks to financial institutions regulated by New York state, it is part of a groundswell of efforts at the state level to address climate-related risk.

In 2018, another New York regulator, the New York Attorney General (NYAG), brought a civil securities fraud case against Exxon Mobil under the state's Martin Act and alleged the company had made material misstatements concerning how it accounted for the costs of climate change regulation.

Although Exxon Mobil prevailed at trial in the NYAG litigation, the Massachusetts Attorney General last year filed a similar lawsuit, which is still pending, alleging that Exxon failed to disclose climate-related risks to its investors.

On the legislative front, recently Illinois passed the Illinois Sustainable Investing Act[2] (ISIA) requiring every Illinois "public agency" and "governmental unit" to incorporate ESG and "sustainability factors" into their investment decisions, particularly when doing so is profitable, minimizes risk, and comports with their fiduciary duties.

That law, in turn, joins the efforts of state pension funds like CalPERS[3] in California and the New York State Common Retirement Fund,[4] which have voluntarily adopted rules requiring consideration of ESG factors in their investment decisions. Other states and municipalities are taking or considering similar steps as well.

NEXT STEPS FOR FINANCIAL INSTITUTIONS

Financial institutions operating under the NYDFS's oversight may wish to consider the following steps for incorporating climate-related risks into their governance, strategy, and risk management.

- Identify business operations subject to increased climate change risks.
- Review company accounting policies to determine whether climate change risks are properly accounted for.
- Create a board committee to review loans, assets, and commercial agreements for climate change risks.
- Include climate change risk analysis in the institution's corporate governance and oversight policies.
- Consider climate change related issues in presenting potential investments and loans to clients and external partners.

CONCLUSION

Climate change risk analysis can help inform a financial institution's business practices and help it better analyze vulnerabilities in asset and lending portfolios. In turn, this can help financial institutions meet regulators' growing expectations that these institutions take greater responsibility for their exposure to climate change risks.

With its recent letter, the NYDFS is taking explicit steps to communicate those expectations to the market. Those steps will almost certainly not be the last.

Notes

1 https://on.ny.gov/3plUicH

2 https://bit.ly/32CTYfl

3 https://bit.ly/36r02ta

4 https://bit.ly/32FFTON

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