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Gearing Up for Climate Disclosure

WRITTEN BY

David W. Ghegan | James W. Stevens | Annette Michelle (Shelli) Willis | Adrianna C. ScheerCook

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Environmental, social, and governance (ESG) matters have become a focal point for investors and regulators. For financial institutions, and other companies, climate risk has become a key component, and an increasingly pressing area of consideration. Climate risk clearly constitutes the "E" in ESG, but it also has implications for the "G." These issues frequently require boards of directors and management to adjust their oversight and risk management structures to account for climate considerations.

Climate risk poses both physical and transition risks that companies will need to confront. Physical risks are defined by the Basel Committee on Banking Supervision as "economic costs and financial losses resulting from the increasing severity and frequency of: extreme climate change-related weather events (or extreme weather events) … ; longer-term gradual shifts of the climate … ; and indirect effects of climate change," such as desertification and water shortage. Physical risks may cause losses to assets and property and disrupt business operations and economic activity. Transition risks are "risks related to the process of adjustment towards a low-carbon economy," which may result in lower valuations of assets.

Some financial institutions have voluntarily started to include disclosures regarding the impact of climate risk in their annual reports or separate sustainability reports. Most financial institutions that make climate disclosures use the Financial Stability Board's Task Force on Climate-Related Financial Disclosures (TCFD) recommendations as a guide. At a high level, the TCFD recommendations seek to orient climate disclosures around four core elements:

1. Governance around climate-related risks and opportunities;

2. The actual and potential impacts of climate-related risks and opportunities on business, strategy, and financial planning;

3. The processes used to identify, assess, and manage climate-related risk; and

4. The metrics and targets used to assess and manage relevant climate-related risks and opportunities.

However, the U.S. federal banking regulators have yet to mandate climate disclosures or incorporate climate risk into prudential supervisory efforts, resulting in differences in scope and detail across financial institutions' efforts. This will likely change in the near future, as the U.S. Securities and Exchange Commission (SEC) has indicated its intention to release a rule proposal on climate risk disclosures at the end of 2021 or in early 2022. The U.S.

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banking regulators have also indicated movements on climate change in response to President Biden's Executive Order on Tackling the Climate Crisis at Home and Abroad from January 27 and Executive Order on Climate-Related Financial Risk from May 20, the goal of which is "to advance consistent, clear, intelligible, comparable, and accurate disclosure of climate-related financial risk."

SEC

SEC Chairman Gary Gensler has been vocal about the importance of climate risk disclosures to his agenda. The SEC is working on a proposal for mandatory climate risk disclosures for public companies, and the proposed rule is now expected to be published late this year or in early 2022. Chairman Gensler has indicated that the disclosures will be both qualitative, such as answering questions on how the company's leadership manages climate-related risks and opportunities, and quantitative, such as providing metrics related to greenhouse gas emissions and the financial impacts of climate risk. Chairman Gensler has also asked SEC staff "to consider whether there should be certain metrics for specific industries," including banking.

For financial institutions subject to SEC oversight, the provisions of these disclosures may prove more complicated than for other industries. As both the Bank Policy Institution and American Bankers Association noted in their responses to the SEC's request for public input on climate disclosures, financial institutions are in a unique position. Due to their activities, financial institutions will be largely reliant on various stakeholders, such as lenders, to gather and provide information on the climate impacts of such borrower's activities. These clients may not be subject to regulatory requirements, and therefore, may not have processes currently in place for the level of data collection that will likely be required. Yet, even for clients that are subject to regulatory requirements, efforts across all industries to collect the types of data suggested by Chairman Gensler are still in early stages. Additionally, once the data required to be collected and disclosed is finalized, financial institutions will still need to develop internal processes to collect and organize this data from clients, which will be time-consuming.

U.S. Banking Regulators

Federal Reserve

On October 7, Federal Reserve Governor Lael Brainard discussed the Federal Reserve's preparations to use scenario analysis to account for physical risks and transition risks facing financial institutions. She stated that a scenario analysis should differentiate between geographic risks and those related to different economic sectors. Ms. Brainard noted that it is important to start "down the path of climate scenario analysis, even with a rudimentary first attempt," to help with risk identification and "inform subsequent improvements in modeling, data, and financial disclosures." She further stated that she anticipates "it will be helpful to provide supervisory guidance for large banking institutions in their efforts to appropriately measure, monitor, and manage material climate-related risks."

On September 24, the Federal Reserve Bank of New York published a staff report setting forth a stress testing procedure to test financial institutions' resilience to climate-related risks. The report develops a measure called CRISK, which is the expected capital shortfall of a financial institution in a climate stress scenario. The development of CRISK could signal a first step toward the development of climate stress testing for financial institutions.

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This report comes after Federal Reserve Chairman Jerome Powell's testimony to the Senate Banking Committee on July 15, where Powell indicated that the Federal Reserve may implement climate stress testing in the future once it has "good data on the implications of climate risk and how to think about that in terms of the risks" to financial institutions. He noted that the use of such tests by the European central banks is "proving to be … a very profitable exercise, both for the financial institutions and for regulators."

In addition, the FRB has established two complimentary committees. The Supervision Climate Committee (SCC) has been tasked with identifying and assessing climate-related risks for financial institutions, as well as developing a program to ensure that financial institutions can withstand such risks. The Financial Stability Climate Committee (FSCC) will identify, assess, and address climate-related risks to the broader financial system.

Office of the Comptroller of the Currency (OCC)

Acting Comptroller of the Currency Michael Hsu has stated that "[p]rudently managing climate change risk is a safety and soundness issue." To accelerate the OCC's efforts with respect to adopting climate risk management practices, the OCC appointed a Climate Change Risk Officer on July 27. The OCC also became a member of the Network of Central Banks and Supervisors for Greening the Financial System (NGFS). NGFS allows central banks and supervisors to share best practices and develop climate risk management in the financial sector.

Federal Deposit Insurance Corporation (FDIC)

FDIC Chairman Jelena McWilliams has indicated that the FDIC "expects financial institutions to consider and appropriately address potential climate risks," as well as to mitigate such risks. She further noted in her testimony before the U.S. House Committee on Financial Services that the FDIC will analyze factors affecting economic and banking conditions and will continue to engage with domestic and international regulatory bodies on programs addressing climate risk.

New York Department of Financial Services (NYDFS)

On October 29, 2020, the NYDFS issued guidance outlining requirements for New York-regulated financial institutions to address climate-driven financial risks. Specifically, NYDFS expects regulated financial institutions to start:

1. Integrating climate-related financial risks into their governance frameworks, risk management processes, and business strategies, including by:

   a. Designating a board member, committee of the board, and senior management function as accountable for the institution's assessment and management of such risks;

   b. Conducting an enterprise-wide risk assessment to evaluate climate change and its impacts on risk factors; and

2. Developing their approach to climate-related financial risk disclosures and considering engaging with the TFCD framework and other established initiatives when doing so.

European Central Bank (ECB)

The efforts of European central banks may provide the U.S. banking regulators with a framework for developing climate stress tests and integrating climate risk into their prudential framework. In November 2020, the ECB published 13 supervisory expectations for banks relating to climate-related and environmental risks. These expectations cover risk management, governance, and disclosures related to climate risk. Among other things, financial institutions are expected to consider and integrate climate-related and environmental risks when developing business strategy, objectives, risk management frameworks, and business continuity plans. Financial institutions are also expected to assign responsibility for management of climate-related and environmental risks, and provide for appropriate oversight of such risks within the organization. Finally, financial institutions are expected to publish "meaningful information and key metrics on [material] climate-related and environmental risks."

The ECB has also announced a stress test for financial institutions to take place in 2022. The test will be informed by the ECB's Economy-Wide Climate Stress Test, which tested the impact of climate change under three different scenarios: (1) climate-specific scenarios that project climate and macroeconomic conditions over the next 30 years; (2) a comprehensive dataset that combined climate and financial information for millions of companies worldwide and approximately 1,600 euro area banks; and (3) a set of climate-specific models that captured the direct and indirect transmission channels of climate risk drivers for firms and banks.

Federal Legislative Efforts

Federal legislators are also making efforts to advance disclosures on climate risk. On April 15, a bill was introduced in the House of Representatives that directs the SEC to require public companies to disclose information regarding climate risks, including the company's strategies and actions to mitigate these risks.

On September 15, the Fossil Free Finance Act was introduced in the House of Representatives. This act would require the Federal Reserve to mandate that bank holding companies with more than $50 billion in assets and Systemically Important Financial Institutions align their financing of greenhouse gas emissions and deforestation risk commodities with certain science-based emissions targets based on the Paris Climate Agreement. Among other things, the act would prohibit financing of new or expanded fossil fuel projects after 2022 and all fossil fuel projects after 2030. It would also prohibit thermal coal financing after 2024. It would also mandate a 50% reduction in financed emissions by 2030 and a 100% reduction in financed emissions by 2050.

Conclusion

Developing processes for collecting and presenting meaningful climate risk disclosures is likely to be a time-consuming and intensive effort. This can be seen in financial institutions' implementation of the ECB's November 2020 supervisory guidance. As of August 2021, roughly 60% of financial institutions envisioned meeting the supervisory expectations relating to business environment management and organizational structure by 2022. However, in other areas, such as aligning credit and liquidity risk management practices, less than 35% of banks expect to meet the supervisory expectations by 2022.

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How can financial institutions do anything to gear up for climate disclosure even though the United States' regulators have not yet provided any definitive guidance? Financial institutions can take several steps to start preparing:

1. **Review current climate and environmental disclosures, if any.** If a financial institution currently provides climate and environmental disclosures, it may be helpful to preliminarily review such disclosures, in conjunction with counsel, against: (1) the TCFD recommendations; (2) the SEC's 2010 Climate Change Guidance; and (3) the SEC's sample letter to companies regarding climate change disclosures. Even if a financial institution will not be subject to the SEC's rules as a reporting company, reviewing climate disclosures against SEC guidance could still be beneficial for investor relations, as increasing numbers of investors are demanding such disclosures. A financial institution should begin to evaluate whether additional fulsome disclosures are necessary, and what processes may need to be instituted to realize such disclosures.

2. **Develop tools to measure the financial institution's baseline and metrics against stated goals.** Measuring these metrics may require a financial institution to obtain data from third parties, such as its suppliers. If that is the case, the financial institution must be mindful of existing requirements to validate and review third-party assumptions, data, and models. The financial institution must also be mindful of existing third-party risk management frameworks that will need to be applied to its relationships with third parties providing information necessary for the financial institution's own climate disclosure.

3. **Evaluate whether oversight processes are in place, or will need to be established, for climate disclosures.** Financial institutions should consider who will oversee climate disclosures on their management team and on the board of directors. ESG reporting has not necessarily been aligned with existing financial disclosures and processes for creating such disclosures, such as audit oversight processes and disclosure committees. However, financial institutions should consider folding ESG reporting, including climate disclosures, into existing frameworks or establishing corollary frameworks that are sufficiently rigorous to withstand the newfound scrutiny of such disclosures by investors and regulators.

4. **Consider the biggest risks that climate risk presents to business and operations in the future.** As the potential for climate risk rapidly accelerates, financial institutions should consider the near-term, as well as long-term, impacts of climate risk and the steps being taken to promote a "greener" economy on their businesses and operations. Financial institutions should also begin to think about the potential impact of these changes on capital.

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