ISDA Safe, Efficient Markets

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February 6, 2023

By electronic submission

Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: Principles for Climate-Related Financial Risk Management for Large Financial Institutions [Docket No. OP–1793]

Dear Ms. Misback:

The International Swaps and Derivatives Association, Inc. and Securities Industry and Financial Markets Association (collectively, the **"Associations"**)[1] appreciate the opportunity to provide input on the Board of Governors of the Federal Reserve System (the "**FRB"**) request for feedback on the Principles for Climate-Related Financial Risk Management for Large Banks (**"Principles**") published in the Federal Register on December 8, 2022.[2]

We appreciate the FRB's intent to closely align the proposed principles with the proposed climate-related financial risk consultations issued by both the Office of the Comptroller of the Currency (**"OCC"**) and Federal Deposit Insurance Corporation (**"FDIC"**). Given the intensifying pace of climate change, it is important to have a continuous dialogue with banking regulators to develop the best approach to the treatment of climate-related financial risks.

With a few exceptions that are set forth below, our comments on the proposed principles are similar to the comments we provided in response to the OCC and the FDIC's proposals.[3] The Associations support the OCC, FDIC and FRB's (collectively, **"agencies"**) goal to ensure the safe management of banks' exposures to climate-related financial risks. We support public sector efforts to establish regulatory principles and

[1] Please see the Appendix for information regarding each Association.
[2] 87 Fed. Reg. 75267 (December 8, 2022) [hereinafter, "Proposal"].
[3] Our respective comment letters are posted on ISDA's website, available at: https://www.isda.org/2022/02/14/response-to-occ-on-principles-for-climate-related-financial-risk-management/; https://www.isda.org/2022/06/17/isda-and-sifma-respond-to-fdic-on-climate-related-financial-risk-management-for-large-banks/.

guidance surrounding climate-related financial risks that is consistent with the existing risk management operational framework.

Our member banks' risk management practices, in the context of climate-related financial risk, have centered around the identification and evaluation of potential climate-related financial risks under different scenarios, specifically focusing on assessing potential materiality for different risks over different time horizons.[4] These efforts have helped identify some inadequacies and challenges, including data limitations and complexities arising from a variety of different scenarios and time horizons.

Despite these efforts, banks are still at a developmental stage of embedding climate-related financial risks into their existing risk management, governance and business planning frameworks as related to material risks. Therefore, as explained in more detail below, given these challenges, we believe it is currently premature to incorporate climate-related financial risks into capital and liquidity adequacy assessment.

Our comments below focus on five (5) key aspects of the Principles:

- **Data**: The availability of relevant, accurate and timely data is the key impediment in quantifying climate-related financial risks into banks' exposures.
- **Scenario Analysis**: Institutions should have flexibility to create their own model designs with the data available based on principles-based regulatory guidance.
- **Responsibility of the Board and Senior Management**: An effective risk-management framework should clearly distinguish and define the role and responsibility of the board relative to senior management.
- **Considerations Related to U.S. Operations of Foreign Banking Organizations ("FBOs")**: The Principles should clarify what type of U.S. presence renders the Principles applicable, and better reflect how FBOs operate and manage risk in the United States.
- **Regulatory Coordination**: As climate-related financial risks are global in nature, regulators should coordinate on a regional and international basis when establishing principles or guidance that address climate risk.

Data

The key challenge that banks face in incorporating climate-related financial risk into their respective risk management frameworks is the fact that data and tools to measure and quantify climate-related financial risk—and in particular, longer-term transition and physical risks—are only just emerging. Such data will need to undergo substantial exploration, refinement, and adaptation over time. Although data capabilities are

[4] To-date, banks have employed various time horizons in determining climate-related risk.

improving, significant gaps in data sourcing, capture, standardization, and aggregation substantially affect the accuracy of projections and risk assessment. For example, there is a growing disparity between the increasing availability of transition risk data as compared to less available physical risk data. Though even for available transition risk data there persist severe data lags in reporting, sourcing and consumption. Consequently, banks' ability to understand and analyze climate change risks is still evolving.

We agree with the FRB's view that sound risk management is significantly dependent on the availability of relevant, accurate, and timely data. We also appreciate that the Principles provide flexibility for banks to tailor their approach to addressing climate-related risks, and acknowledge that the development of bank risk management frameworks to embed climate-related financial risks is iterative and will continue to evolve alongside wider developments, such as the availability of better quality, and more specific data.[5] Such a flexible approach is important in this area; for example, given the higher liquidity and shorter-term nature of trading book positions, banks may not deem particular climate-related financial risk as material, and thus, should have flexibility around how to incorporate climate risk into market risk measurement.

As drafted, the Principles may be too prescriptive with respect to banks' risk management practices and could contradict the FRB's intent to support a flexible principles-based approach and integration of climate-related risks as proportional to a banks' size, portfolio and businesses mix. We believe that, instead, climate-related risk tolerances should be integrated into existing broader risk-management frameworks.

Accordingly, any additional guidance published subsequent to these Principles should continue to take a flexible approach, encouraging banks to individually consider, with the data then available, how climate-related financial risks impact their business and risk management frameworks.

Scenario Analysis

We agree with the agencies that climate-related scenario analysis is an important tool that can be used to explore the potential impacts of climate-related financial risks on banks' portfolios and the overall business model. We recognize that such an exercise could help understand potential impacts, limitations, and could provide guidance on potential next steps for integrating climate-related financial risk.

We share the agencies' view that firms should develop and implement climate-related scenario analysis frameworks proportional to the bank's size, complexity, business activity, and risk profile. To-date, our members are actively engaged in developing their

[5] Proposal at 75268-75269.

scenario analysis capabilities and running exercises across different parts of their portfolios.

It is important to reach a consensus on available scientific and economic forecasts and a range of scenarios so that individual banks can then tailor their approach to reflect their specific business models and risk profiles. For example, the Network for Greening the Financial System, Representative Concentration Pathways, and International Energy Agency's scenarios can be used as a starting point to meet risk management and other internal scenario analysis needs. In addition, where the Principles apply to FBOs, those firms should also be given flexibility either to rely on the application of scenario analysis at group level, or to apply the scenario analysis developed elsewhere to their relevant U.S. operations.

Currently, publicly available climate scenarios do not provide banks with the appropriate sectoral and regional granularity to translate scenario output into readily consumable inputs for internal risk modeling. For banks, the value of climate scenario analysis can only be fully realized when the science-based or macroeconomic output is expanded into more granular financial impacts that can be applied across a diverse set of client industries and sub-sectors. Additionally, there is still a limited understanding of the climate economic models that drive these scenarios, which makes it more challenging for banks and vendors alike to expand scenario output while staying within the bounds of the model.

At this time, given these challenges, scenario analysis should be considered an exploratory exercise that enables firms to identify key areas of the business model that could be impacted by climate risk (both transition and physical) events. Conducting such exercises should also inform an individual firm's modelling strategies as the industry gradually develops more sophisticated capabilities. Indeed, many of our members are participating in industry-wide initiatives that look into developing scenario analysis frameworks and methodologies to assess climate-related impact. Since these initiatives are at their early stages, any guidance from the agencies should be principle-based and should allow institutions to create their own model designs with the information at-hand. We note that ISDA published a paper in Q4 2022[6] to provide a better understanding of the issues and challenges banks are facing when using scenario analysis for assessing climate risk.

[6] *See* ISDA and EY, Climate Risk Scenario Analysis for the Trading Book (Oct. 2022), *available at* https://www.isda.org/2022/10/20/climate-risk-scenario-analysis-for-the-trading-book/.

<u>Responsibility of the Board and Senior Management</u>

We appreciate that the draft Principles appropriately delineate the role of the board and management with respect to climate-related financial risks. We agree that any final principles should reflect the board's role as an oversight body that provides strategic direction to management and holds management accountable for the implementation of such strategies, including any directives to address climate-related financial risks. We also appreciate that the Principles place more direct responsibilities on monitoring the impact of climate-related financial risks on the banks' management. Such responsibilities are better suited for senior management and key staff who have access to the day-to-day information and can create and amend policies within the bank based on the available information. Blurring the lines between the roles of the board and management could run counter to the Principles' objective of ensuring a strong internal governance structure to address climate-related financial risks. Similarly, we believe that the board should not have direct responsibility over public statements about their institutions climate-related strategies. This responsibility should be left with management as they are better placed to ensure that statements regarding climate-related strategies are linked to climate risk management given that they are responsible for implementing the firm's climate strategies.

In addition, it's important to recognize that banks have different internal structures and may assign responsibilities across the banks in different ways. In order to ensure that climate-related financial risks are appropriately incorporated across a bank's structure, they must be flexible enough to seamlessly fit within various structures. By the same token, the Principles should clarify how board and senior management responsibilities should be applied with respect to FBOs, and should do so in manner that leverages established U.S. risk governance frameworks for FBOs.

Separately, it may be inappropriate for the board to consider changes to compensation policies based solely on climate-related financial risk. Compensation related metrics are currently designed in accordance with FRB guidance to ensure consistency with a bank's strategy, risk appetite, and safety and soundness. Banks are already appropriately calibrating compensation with the firm's priorities.

Accordingly, any final Principles should: (1) clearly delineate between the oversight role of the board versus the obligations of senior management, (2) provide flexibility to account for various bank structures, (3) specify how board and senior management responsibilities should be applied with respect to FBOs in a manner that leverages established U.S. risk governance frameworks for FBOs, (4) not consider changes to compensation policies based solely on climate-related financial risk, and (5) acknowledge that direct responsibilities over public statements related to climate strategies is beyond the scope of the board's responsibilities. Additionally, the FRB should encourage the

FDIC and OCC to finalize their respective proposed principles in line with the approach outlined above.

Considerations Related to FBOs

The FRB should provide more clarity regarding the application of the Principles to FBOs to reflect the governance specificities for how FBOs operate and manage risk in the United States and build upon established FRB U.S. risk expectations and U.S. risk governance frameworks for FBOs.

It's important to recognize that climate-related financial risk management is often an enterprise-wide effort that is routinely developed and coordinated at home office or group-level. Accordingly, FBOs should be able to leverage home office or group-level programs, policies, models, and procedures, and boards should be able to rely on designated U.S. committees and existing U.S. risk governance (e.g., a U.S. risk committee, or other relevant committee or entity) regarding the board oversight of climate-related financial risks in the United States. In addition, FBOs should also be able to rely on U.S.-based management for relevant U.S. climate-related financial risk obligations for senior management.

Moreover, based on footnotes 1, 4 and 8 of the Principles,[7] it is unclear how the Principles may apply to FBOs. The FRB should therefore clarify that the Principles apply to FBOs in a consistent manner based on the size of their combined U.S. operations.

Regulatory Coordination

Given a fast-evolving landscape, the effective global coordination of prudential and supervisory principles is critical. Our members are keen on global financial regulators developing common principles on how to address climate-related financial risks across the financial system.

Global regulatory coordination will allow banks to embed climate-related financial risks into their risk management frameworks, including across operating entities in different

[7] *See* footnote 4 of the Proposal ("In this issuance, the term 'financial institution' or 'institution' includes state member banks, bank holding companies, savings and loan holding companies, intermediate holding companies, foreign banking organizations with respect to their U.S. operations, and non-bank systemically important financial institutions (SIFIs) supervised by the Board."); footnote 8 of the Proposal ("The Board will consider the total consolidated assets of a branch or agency itself for branches and agencies of foreign banking organizations subject to Board supervision").

jurisdictions in a consistent manner. Any finalized Principles should address the need for harmonized supervisory principles, domestically and internationally.[8]

In this regard, we would welcome additional, coordinated guidance from the regulatory community in the following areas:

- Consensus around scientific and economic forecasts and further international coordination and collaboration on the development of climate-risk models;
- Solutions to overcome a lack of relevant granular data and development of robust climate-related financial risk model frameworks; and
- Collaboration between prudential and market regulators to mitigate any unintended negative impacts on capital markets, including transition finance market.

[8] *See, e.g.,* Basel Committee on Banking Supervision, June 15, 2022. *Principles for the effective management and supervision of climate-related financial risks*, https://www.bis.org/bcbs/publ/d532.htm.

Conclusion

We appreciate the opportunity to submit our comments in response to the Principles for Climate-Related Financial Risk Management for Large Banks. We commend the FRB for considering these important issues.

Our members are strongly committed to maintaining the safety and efficiency of the U.S. financial markets and recognize that banks have a big role to play in the management of climate-related financial risks. We hope that the FRB will consider our suggestions, as they reflect the extensive knowledge and experience of financial market professionals within our memberships.

Please feel free to contact Panayiotis Dionysopoulos (+44 (0)20 3808 9729), Bella Rozenberg (646-515-0567), or Guowei Zhang (202-962-7340) should you have any questions or seek any further clarifications.

Bella Rozenberg
Senior Counsel and Head of Legal and Regulatory Practice Group
ISDA

Guowei Zhang
Managing Director, Head of Capital Policy
SIFMA

Appendix

Overview of the Associations

Since 1985, **ISDA** has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 79 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.

The **Securities Industry and Financial Markets Association** is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of its industry's nearly one million employees, SIFMA advocates on legislation, regulation and business policy affecting retail and institutional investors, equity and fixed income markets and related products and services. SIFMA serves as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance and efficient market operations and resiliency. SIFMA also provides a forum for industry policy and professional development.