

Threading the Needle

Preemptive Strategies for Managing Climate-Related Risks

BY ERIC WISCHMAN

WHETHER YOU ARE WATCHING THE EVENING NEWS, experiencing unusual weather in your community, or witnessing debates in the political arena, it's impossible to avoid the discussion on climate change. The noise can be deafening, complemented by a lack of consensus on potential impact, likelihood, and the appropriate level of government intervention. Many have strong personal views on this topic, which land on a broad spectrum. Therefore, it's highly unlikely that the views across all employees within a financial institution (FI) are universally aligned.

For risk management leaders, the confluence of these internal and external factors creates a complicated landscape to navigate. That said, this moment also provides an excellent opportunity for us to ground our organizations on climate change within a traditional risk management construct that resonates with all stakeholders. Removing ourselves from the noise and the emotion, climate risk may pose a material emerging risk for any FI. A blend of traditional risk management practices and new approaches will significantly aid in determining that risk and the extent to which climate risk should be integrated into our existing risk management practices.



Climate risk is defined as the risk to assets, investments and strategic goals resulting from the impact of a changing climate on our customers, communities, and operations.

Climate Risk Defined

Climate risk is defined as the risk to assets, investments and strategic goals resulting from the impact of a changing climate on our customers, communities, and operations. These risks are organized within two key sub-categories:

Physical Risks:

Physical risks are defined¹ as the harm to people and property arising from acute, climate-related events, such as hurricanes, wildfires, floods, heatwaves, and chronic shifts in climate, including higher average temperatures, changes in precipitation patterns, sea level rise, and ocean acidification. We’ve witnessed a growing number of extreme events that may impact our operations, customers, and communities.

Examples include a one in a thousand-year rainfall event in the Los Angeles area during February, significant wildfires in Eastern Canada and, rare flooding in Vermont last summer. There are longer term consequences to such events, as weather-related events have served as a contributing factor to a trend by insurance carriers not to renew policies in certain regions. Regions less likely to experience wildfire or flooding are not immune from concern, as they may be exposed to other risks, such as extreme temperatures and wind-related hazards.

For some initial perspective, the Federal Emergency Management Agency (FEMA) maintains a National Risk Index,² which provides a helpful interactive map across numerous hazard categories. While not specific enough in many cases to appropriately assess the risks associated with a specific property, the data within can be helpful in identifying and prioritizing physical risks within the region where collateral and operations are located. (See Table 1.)

Transition Risk:

Transition risk represents the stresses to institutions or sectors arising from the shifts in policy, consumer, and business sentiment, or technologies associated with the changes as part of a transition to a lower carbon economy. These activities are intended to result in a decrease in emissions, thereby improving the likelihood that the rising global temperatures will be less severe, resulting in a more stable planet and fewer physical risk impacts.

Table 1

Category	Example
Policy and Regulation	<ul style="list-style-type: none"> • Tax credit incentives to change consumer behavior • Carbon tax on green house gas emissions • Regulations that require changes to building standards and requirements
Technological Advancement	<ul style="list-style-type: none"> • Increased reliability and decreased costs associated with solar and wind power • Improved performance of battery technology
Consumer Preference	<ul style="list-style-type: none"> • Preference to pay for goods produced through sustainable methods • Personal efforts to reduce carbon footprint (e.g., electric vehicle purchases)

Many companies have made net-zero commitments and shaped a long-term strategy around efforts to slow rising temperatures. It remains unclear whether these companies and the economy at large will be able to meet such commitments as there are significant headwinds. Regardless of whether net-zero goals are met, there are numerous potential transition risks to your institution that need to be considered. There are already sectors within industries that are at risk of becoming obsolete or are likely to experience financial strain as capital expenditures increase as part of a transition. Further, embedded within the category of policy and regulation is the reality that some states are taking more aggressive legislative actions to encourage a transition to a lower carbon economy. In some instances, these laws may negatively impact the financial viability of our customer’s business models.

The Evolving Regulatory Landscape

Over the last 24 months, the regulatory landscape has continued to evolve at both the federal and state level. During the fourth quarter of 2023, multiple new regulatory expectations were finalized. There is a growing trend that regulatory agencies will expect FIs to integrate climate risk management practices into existing risk infrastructure sufficiently to ensure safety and soundness

of both the FI and more broadly the financial system. Further, there could be a trend where multiple states require companies to disclose climate risk-related practices publicly.

Of note, all banks regulated by the New York State Department of Financial Services will need to address adherence to its recent guidance. California's disclosure laws may apply to our institutions, customers, and our third-party relationships, particularly given the broad definition for conducting business in California.

Further, publicly traded companies must closely assess the impact of the Securities and Exchange Commission (SEC) Final Rule regarding the Enhancement and Standardization of Climate-Related Disclosures for Investors by understanding the requirements and the associated phased timing. Regardless of the specific applicability, FIs must now consider how best to perform a sufficient level of identification, assessment, and measurement, in a properly controlled framework/process, to meet accuracy control standards for such disclosures.

Lastly, developments at the state level need to be closely monitored due to the number of laws enacted (or in discussion), the scope of these laws and the reality that not all of these are intended to achieve the same outcome. For example, the Texas Legislature in 2021 enacted Senate Bill 13, which requires state entities to divest from companies (including banks) that have boycotted fossil fuel companies. While state-level laws in states such as California and Texas are not in immediate and direct conflict, this situation results in a dynamic where risk management leaders need to understand the potential impacts of regulations and consider how your FI intends on responding to these developments in a manner that aligns with its long-term strategy.

Finding Similarities In Existing Risk Management Practices

The risk management playbook of identify, assess, measure, monitor, mitigate, and report should be applied to any risk management discipline. The application of these varies. These six critical risk management elements are like guitar strings. They all need proper tuning, and you need to know when and how to press the right strings to ensure the desired results are achieved. Climate risk will simply require learning some new chords.

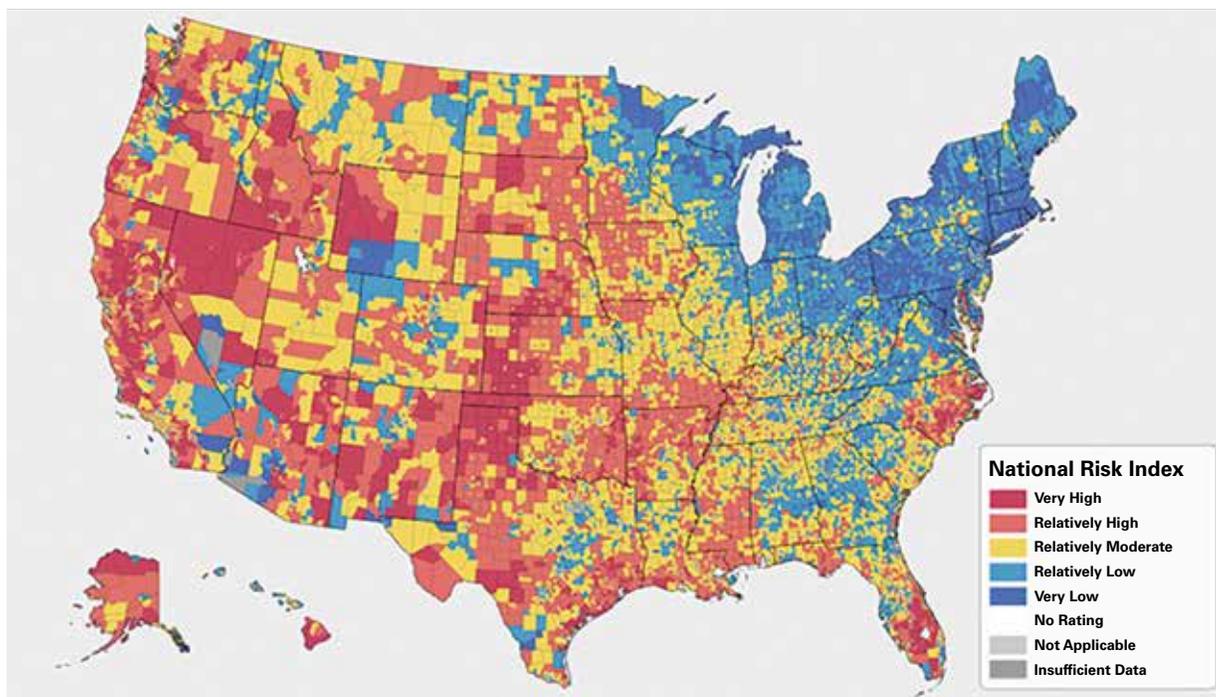
Start by analyzing climate risk across these key elements with an initial focus on identifying and assessing potential climate risks. As the concept of climate risk gained traction in the United States, there were early discussions of creating a separate climate risk pillar. A more conventional approach would be to view climate risk as an emerging risk and consider how it may impact existing risk pillars. There will likely be risks and considerations in all institutions with respect to credit, operational, strategic, and reputational risks. Additionally, many may also identify liquidity, market, and legal risks.

Challenges to Managing Climate Risk

While applying traditional risk management methodology is critical to dissecting and organizing climate risk management activities, such risks present the following challenges and need to be acknowledged.

■ **Geopolitical and Economic Volatility.** A volatile and uncertain economic and geopolitical landscape decreases the ability to predict outcomes. In addition to identifying shorter term risks, regulatory expectations and industry methodology are simultaneously encouraging the exploration of risk over time horizons

FEMA National Risk Index — Census Tract Illustration



Purpose	Regulation	Agency	Applicability	Summary
Safety & Soundness and Resiliency	Interagency Principles for Climate-Related Financial Risk Management for Large Financial Institutions	Federal Reserve Bank (FRB), Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC)	Greater than \$100 billion in total consolidated assets	Principle-based guidance, which articulates that climate risk must be properly identified, assessed, and incorporated where appropriate into risk management activities across all risk pillars, including risk appetite, board education and oversight.
	Guidance for New York State Regulated Banking and Mortgage Institutions Relating to the Management of Material Financial and Operational Risk from Climate Change New York State	New York State Department of Financial Services	All New York State-regulated banking organizations, New York State-licensed branches and agencies of foreign banking organizations, and New York State-regulated mortgage bankers and mortgage servicers.	Objective consistent with interagency guidance implemented by federal banking regulators.
Disclosure and Transparency	The Enhancement and Standardization of Climate-Related Disclosures for Investors	Securities and Exchange Commission	Publicly traded companies, with phased implementation across both requirements and filing status.	Requires disclosure of material climate-related risks; activities to mitigate or adapt to such risks; information about the registrant’s board of directors’ oversight of climate-related risks and management’s role in managing material climate-related risks; and information on any climate-related targets or goals that are material to the registrant’s business, results of operations, or financial condition. In addition, disclosure of Scope 1 and/or Scope 2 greenhouse gas (GHG) emissions.
	Climate Corporate Data Accountability Act (Senate Bill 253)	State of California	Public and private companies doing business in California with annual revenue in excess of \$1 billion.	Requires disclosing emissions data, including scope 3 emissions, with safe harbor for scope 3 disclosures made with reasonable basis.
	Climate-Related Financial Risk Act (Senate Bill 261)		Public and private companies doing business in California with annual revenue in excess of \$500 million.	Prepare and submit climate-related financial risk reports in a manner with recommendations from the Task Force on Climate-Related Financial Disclosure (TCFD).

that far exceed normal risk planning (e.g., 5, 10, 15, 20 years). Over the course of these time horizons, it is highly likely that macroeconomic issues (e.g., inflation) will distort focus on a transition to a lower carbon economy, which will impact the pace and cohesiveness of transition efforts. Geopolitical issues, such as more recent energy issues in Europe resulting from Russia’s invasion of Ukraine, will further blur the picture of the timing and extent of transition. In many cases, depending upon the size of the institution, analysis of multiple scenarios will be an important consideration to consider multiple potential outcomes.

■ **Transition Risk Assessment Complexity.** Assessing the likelihood of transition risk is complex and the specifics are critical and elusive. Additional information is required to understand transition risk at the customer level, such as financial performance and specifics about the business model. Similarly, specific location (i.e., latitude/longitude) is critical to being able to measure important physical risks.

■ **Internal and External Data Challenges.** Undoubtedly, this is a common theme for us all. External data is needed to perform this analysis. While some vendors offer very beneficial data and insight, they are in limited supply. In merging external and internal data, you may learn that internal data is an equal challenge. Some internal data challenges are new. For example, from a BSA/AML Customer Identification Program standpoint, there must be a valid

address on file for customer but, if that address is not representative of the location of collateral, it may be of far less value from a climate risk standpoint.

■ **Unclear Regulatory Expectations.** Often with principle-based guidance, the interpretation of the language within has significant bearing on how guidance and rules are implemented. Regulators are actively working to determine how best to implement finalized guidance and in doing so recognize the challenges. While the timeline is uncertain, the inevitability that examiners will expect banks to be able to speak to climate risk as a potential material emerging risk seems in little doubt.

Analysis completed in consideration of these realities is not in vain. Every risk issue has its level of ambiguity and appropriately understanding potential outcomes will result in an FI more prepared to manage through the unpredictable ebb and flow.

Considering Proportionality

As with any matter, the size and the complexity of an institution needs to be considered when contemplating the integration and management of climate risks. It’s not uncommon for larger banks to share the initial brunt of regulatory scrutiny. In addition to regulatory scrutiny that is likely to expand over time, consider concentration risk for a moment before concluding that this is a “big bank issue.”



Transition risk represents the stresses to institutions or sectors arising from the shifts in policy, consumer, and business sentiment, or technologies associated with the changes as part of a transition to a lower carbon economy.

Concentration is a reoccurring theme. In many cases, it serves as a key consideration when assessing the potential impact of these risks. The extent of your geographic concentration may have a significant correlation to the extent the community and the customers your bank serves are impacted by a physical risk event. This correlation was articulated in March of 2022, “Climate-Related Financial Risk and Bank Size: When Bigger is Smaller.”²³ The analysis concluded that despite some limitations to the data, in comparing county level FEMA data to OCC data on the number and amount of small business loans, that the largest banks exhibited the least significant exposure to climate related financial risks. For example, the analysis noted that the bank with the highest exposure to physical risk in the nation had a total asset size of \$9.3 billion. Simply put, larger banks can more easily diversify certain climate risks than regional or community banks.

A favorite cartoon for many growing up was G.I. Joe. It famously concluded each episode with the adage, “knowing is half the battle,” and truer words were never spoken when considering climate risk. Start by focusing on the identification and assessment of potential climate risks to your institution,

The appropriate breadth and depth of additional risk management efforts will be much easier to determine after the initial analysis is completed. Important initial steps include, understanding the physical risk exposures within the geographies of your operations and collateral, the regulatory requirements that apply to the institution, and trends in its footprint, along with analysis of industries that are inherently more sensitive to a transition to a lower carbon economy.

Final Thoughts

As efforts to manage climate risks begin, consider the following:

- Find common ground with all key stakeholders in your organization by rooting discussions on climate risk in developing the capabilities and tools to properly identify and assess the risk. Let the outcomes of this work speak for itself and dictate next steps. Ask the stakeholders to leave their politics and emotions at the door.
- Develop an initial understanding and continually monitor the impact of regulations at the federal, state, and municipal level.
- Given that the topic of climate change is impossible to avoid, and that is also true for board members, be mindful and prepared to respond to questions from the board regarding the level of exposure the FI has to climate risk.
- To the extent your FI is publicly traded, and the SEC rule is finalized, and/or California SB 261 is already applicable, you will need to strongly consider developing the internal capabilities and controls necessary to disclose climate risks and related practices with an adequate level of confidence.
- In assessing transition risk, recognize there is likely additional work to be completed to measure customer specific level residual risk more accurately. While industry classification codes are a very good measure of industries that are inherently more sensitive to transition, the risk associated with specific customers within a sector may vary significantly. This could be

the result of numerous factors, including a niche role that the customer plays within a sector that makes them less sensitive to transition risk, or the customer already being well prepared for transition.

- Ownership is critical to making progress. In many cases after doing a sufficient level of identification and assessment, your institution may determine that climate risk does not need to be an employee’s full-time responsibility in the near term. While that may be completely reasonable, institutions may want to consider, at a minimum, adding climate risk to a risk management leader’s responsibilities or performance objectives. ■

The information in this article does not reflect the views or the opinions of M&T Bank.

ABOUT THE AUTHOR

ERIC WISCHMAN is an Executive Vice President at M&T Bank, serving as its Climate Risk Officer and Conduct Risk Director. In his 23 years with M&T Bank, he has served in various risk management roles, including BSA/AML/OFAC Officer and Enterprise Risk Director responsible for developing and implementing the Bank’s risk framework, risk appetite statement, risk governance committee structure and enterprise risk reporting. His experience includes working closely with the Risk Committee of the Board of Directors and members of executive leadership. Eric is a member of the Risk Management Association (RMA) Climate Risk Consortium, Bank Policy Institute Climate Working Group, ABA Climate Task Force, RMA Conduct and Culture Working Group and the Federal Reserve Bank of New York Financial Services Industry Culture and Behavior Risk Forum. He has a Bachelor of Environmental Science and MBA from St. Bonaventure University. Reach him via email at wischman78@gmail.com or by telephone at (716) 984-2028, or [LinkedIn.com/in/eric-wischman](https://www.linkedin.com/in/eric-wischman).

Endnotes

1. Physical risk and transition risk definitions sourced from the Interagency Principles for Climate-Related Financial Risk Management for Large Financial Institutions, October 2023.
2. Map | National Risk Index ([fema.gov](https://www.fema.gov))
3. Dr. Sean Campbell, Chief Economist and Head of Policy Research at the Financial Services Forum

ABA MEMBER RESOURCES

ABA Advocacy: Climate Change

[aba.com/advocacy/our-issues/climate-change-and-banking](https://www.aba.com/advocacy/our-issues/climate-change-and-banking)

ABA Statement: Climate Change and Banking

[aba.com/advocacy/policy-analysis/climate-change-and-banking](https://www.aba.com/advocacy/policy-analysis/climate-change-and-banking)