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Federal Reserve Announces Pilot Climate Scenario Analysis Exercise Details

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Last week, the Federal Reserve Board ("FRB") announced additional details on its pilot climate scenario analysis ("CSA") involving six of the largest U.S. banks. The additional details include a Participant Instructions Document that calls for submissions by the participating banks by July 31, 2023. The FRB anticipates that it will publish insights and aggregate data from the exercise at the end of 2023. The FRB stated: "[t]his pilot CSA exercise will support the Board's responsibilities to ensure that supervised institutions are appropriately managing all material risks, including financial risks related to climate change."

As noted in the FRB's announcement, the "CSA exercise comprises two separate and independent modules: a physical risk module and a transition risk module. Physical risks represent the harm to people and property that may result from climate-related events, while transition risks represent stresses that may result from the transition to a lower carbon economy."

In the physical risk module, the FRB set a severe hurricane hitting the northeast of the United States as the common shock scenario. Each of the participating banks also were directed to select an idiosyncratic shock. The banks will apply those shocks to their residential and commercial real estate loan portfolios and analyze the direct and indirect impacts of such a shock on those portfolios. In the transition risk module, the FRB instructed banks to consider "the impact on corporate loans and commercial real estate portfolios using a scenario based on current policies and one based on reaching net zero greenhouse gas emissions by 2050."

The FRB made clear that the "climate scenarios are neither forecasts nor policy prescriptions and do not necessarily represent the most likely future outcomes or a comprehensive set of possible outcomes." The FRB went on to highlight the difference between this exercise and regulatory stress tests, noting that the CSA exercise “is exploratory in nature and does not have consequences for bank capital or supervisory implications.”

Notwithstanding the additional details the FRB has provided on the CSA exercise, the Federal Reserve continues to emphasize that, as Chairman Powell said last week, the FRB is not a climate policymaker. Vice Chair of Supervision Michael Barr was quoted in the press release reiterating those sentiments, stating that “[t]he Fed has narrow, but important, responsibilities regarding climate-related financial risks – to ensure that banks understand and manage their material risks, including the financial risks from climate change. . . . The exercise we are launching today will advance the ability of supervisors and banks to analyze and manage emerging climate-related financial risks.”

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