ICBA
Independent Community Bankers of America®

# CLIMATE CHANGE REGULATION ON COMMUNITY BANKS:
## Risks of Choking Off Credit to America's Communities

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# Introduction

With decades of experience managing concentration risks and natural disasters, community banks are seasoned experts at monitoring the overall risk of their lending and investment portfolios and do not need additional regulation to manage their potential climate risks. ICBA will oppose any climate risk regulation that adversely impacts community banks and their ability to support their communities and customers.

# Background

***REGULATORY INITIATIVES***

The Biden administration and the 117th Congress are increasingly focused on climate change and are pressuring the financial regulatory agencies to do more to address the issue. Although the banking agencies have not made any specific proposals yet, the Federal Reserve has established a Supervision Climate Committee to further analyze the potential implications of climate change for financial institutions, infrastructure, and markets. In addition, the Office of the Comptroller of the Currency (OCC) announced the hiring of a climate change risk officer to enable the agency to be "more proactive in accelerating the development and adoption of robust climate change risk management practices, especially at the larger banks." Furthermore, President Biden issued an executive order directing Treasury Secretary Janet Yellen to assess the efforts by Financial Stability Oversight Council member agencies to integrate consideration of climate-related financial risks into their policies and programs and to recommend actions for mitigating such risk.

Just recently, the comment period closed on the Securities and Exchange Commission's (SEC) request for public input concerning mandatory climate change disclosures. SEC Chairman Gary Gensler has indicated that a specific proposal is likely to be issued by the end of 2021. While such a proposal would only apply to publicly held companies whose securities are registered with the SEC, it could serve as a model for the banking regulators as they consider climate change disclosure requirements.

Chairman Gensler has been the most vocal advocate for robust climate change disclosures thus far. He has instructed SEC staff to include in the agency's proposal Scope 1 and Scope 2 disclosures, which measure the reporting companies' greenhouse gas emissions and use of fossil fuels, and to consider Scope 3 disclosures, which are the greenhouse gas emissions of firms with whom the reporting company does business. If adopted, Scope 3 reporting would place tremendous new burdens on community banks and likely lead them to withdraw from certain markets and reduce or eliminate lending to certain businesses.

### *LEGISLATIVE INITIATIVES*

Several bills concerning climate change regulation have been introduced in the House and Senate. Two were approved by the House by a vote of 215-214 in a legislative package that included the Corporate Governance Improvement and Investor Protection Act (H.R. 1187). One of those bills, the ESG Disclosure Simplification Act (originally H.R. 1187), would require publicly traded companies to disclose and define environmental, social, and governance (ESG) metrics and the link between ESG and long-term business performance. The Climate Risk Disclosure Act (formerly H.R. 2570) would direct the SEC to issue rules for a public company to annually disclose its direct and indirect greenhouse gas emissions, total amount of fossil fuel-related assets, physical and transition risk management strategies, and how its valuation would be affected by climate change.

Other bills introduced in Congress include S. 1549, which would require federal banking regulators to include climate risk in their supervisory guidance, and H.R. 3571, which would require the Federal Reserve to conduct stress tests on large financial institutions to measure their resilience to climate-related financial risks. Climate change legislation could be included in the Budget Reconciliation Act, in which case it could be approved in the Senate by a simple majority vote.

While the U.S. banking regulators are still in the early stages of developing parameters to measure a bank's exposure to climate risks, the Bank of England recently directed its supervised banks to perform a detailed analysis of their top 100 counterparties based on their exposures. This analysis is to include default and loss projections over an extended timeline from five to 30 years.

# Community Banks and Climate Risk Regulation

Any government attempts to reduce carbon emissions should concentrate on the industries that produce carbon and not on the community banking industry. **ICBA opposes any climate change regulation that will adversely impact community banks and their ability to support their communities and customers.**

Specifically, ICBA will resist efforts by lawmakers and regulators to impose or to incorporate as part of their supervision and examination:

- Hard concentration limits on any type of legal lending, including lending to fossil fuel or other carbon-intensive industries.
- Community bank stress testing or scenario analysis based on adverse climate change assumptions.
- Mandatory climate change disclosure requirements by community banks.
- Capital requirements based on climate risks.

As the leading lender to small businesses, making more than 60 percent of all small-business loans under $1 million, community banks help create and support hundreds of thousands of jobs throughout the nation. Restricting the ability of community banks to provide credit to small businesses could result in devastating unintended consequences affecting national, state, and local economies.

ICBA supports providing incentives to industries deemed to be affected by climate change if such incentives reward current and future voluntary practices and if such effects are verified by accurate scientific analysis. Such incentives could include carbon sequestration or other climate change mitigation efforts. However, if the United States is to maintain economic competitiveness, it should ensure that American businesses—including community banks and their small business, farm, and ranch customers—can operate efficiently without undue cost burdens imposed by climate change regulations or legislation.

# Mandatory Climate Risk Regulation for Community Banks Is Unnecessary and Overly Burdensome

### *LENDING AND INVESTMENT*

Subjecting community banks to mandatory climate risk regulation would be unnecessary and burdensome. Because they know their customers and communities, community banks are in the best position to monitor the overall risk of their own portfolios and banking practices. Community banks have every incentive to safeguard their overall risk through proper practices. They conduct due diligence and use thorough underwriting practices to assess the level of risk in each customer relationship and ensure that controls are in place to identify and monitor these relationships and risks on an ongoing basis. In many instances, they will shorten the maturity of their loans to protect themselves from interest rate risk and many different types of underwriting risks, including climate risks.

With respect to their lending and investment activities, community banks are keenly aware of the importance of risk mitigation, particularly during times of economic stress. In addition to flood insurance and crop insurance, community banks employ many types of risk mitigation techniques to manage lending risks, such as providing guaranteed loans through the Small Business Administration and U.S. Department of Agriculture, which protect up to 90 percent of loan principal should borrowers suffer significant losses. If the risks are significant, community banks may tighten their underwriting standards, employ risk mitigation strategies, boost their loan-loss reserves, or increase their capital levels.

### *CONCENTRATION RISKS, NATURAL DISASTERS, AND STRESS TESTING*

Community banks have decades of experience managing concentration risks and are experts at knowing when and how to reduce their loan concentrations during economic downturns. Since the 2008 economic downturn, the banking agencies have also closely monitored loan concentrations and in some cases required community banks to mitigate their risk. Similarly, since the early 19th century, community banks have successfully dealt with all sorts of natural disasters, including catastrophic hurricanes, tornadoes, flooding, and the great Dust Bowl of the 1930s. In short, community banks do not need additional supervision or regulation to manage their potential climate risks.

Beginning in 2023, most community banks will need to adopt the new current expected credit losses (CECL) accounting standard for computing their allowance for loan and lease losses, or ALLL. Bankers will be expected to integrate the risk assumptions (including, if material, climate risks) used in their CECL estimates for loan losses with those used in their asset-liability management and capital management. In many cases, they will be required to stress test those risk assumptions and loan-loss estimates. Therefore, because bankers will need to incorporate all risks (including climate risks) into their estimates of loan-loss reserves and to stress test those estimates, additional separate requirements to stress test for climate risks would be duplicative and unnecessary.

### *DISCLOSURES*

Because the shareholder base of most community banks and bank holding companies is small, any mandatory climate change disclosures would be considered burdensome to community banks and would be viewed similarly to “Operation Chokepoint”—i.e., an attempt to discourage banks from doing business with certain legal but disfavored industries, such as carbon-intensive industries. Most community banks are either family owned or closely held. Even the larger publicly held community banks often have no more than a few hundred shareholders. There would be little “investor” value in requiring these banks to make disclosures about climate risks.

In a letter responding to the SEC’s request for input on mandatory climate risk disclosures, ICBA told the SEC not to politicize the agency and jeopardize its independence by taking a position on climate change and requiring annual disclosures of climate risks by all SEC filers. Instead, the agency should continue to rely on the existing disclosure regime, which requires disclosures of climate risks only when the company considers them material to an investor.

# Significant Challenges to Reliable and Consistent Disclosures—Safe Harbors Are Needed

Achieving effective disclosure from financial institutions is contingent on the quality and comprehensiveness of disclosure by their corporate counterparties. For instance, to determine the exposure of a community bank's commercial lending portfolio, the bank would need to rely on the representations made by its commercial borrowers. Therefore, consistency in disclosures made by counterparties is essential to an effective disclosure program. Without such consistency, banks will be unable to comply with any prescriptive requirements issued by the SEC or a bank regulator.

Community banks are particularly reliant on their core and other critical third-party service providers for retrieving the data necessary to determine their exposure to climate change. Banks and their corporate counterparties should use the same metrics to calculate climate risk exposure.

There are many metrics proposed across the many established and emerging climate disclosure frameworks that attempt to measure different aspects of information or use different measurement approaches.
To ensure consistency and comparability across markets and to avoid regulatory fragmentation, a recognized and uniform baseline framework for reporting climate-related information that allows for flexibility to allow data, model, and metric improvement is needed.

Disclosure requirements also need to include safe harbor protections broad enough to encourage companies to be candid but narrow enough to ensure that the information provided is useful. Not only should the existing SEC safe harbor rules on forward-looking statements apply, but there should also be specific climate safe harbor rules for any statements that necessarily rely on data from third parties that are outside of the financial institution's control. Any disclosure requirements should also provide long transition periods to comply, particularly for community banks.

Even with a reliable and consistent disclosure system, it would be a formidable task for a community bank and its core service provider to assemble enough information from its counterparties to make accurate Scope 3 disclosures about climate risks. If climate change disclosures are required, community banks should at a minimum be exempt from making Scope 3 disclosures.

# Conclusion

Through its internal Climate Risk Working Group, ICBA will continue to monitor developments concerning climate risks that impact community banks. While we support certain incentives to industries affected by climate change, we will oppose any regulation that will adversely impact community banks and their ability to serve their customers and communities.

# About

## ICBA

With nearly 50,000 locations nationwide, community banks constitute 99 percent of all banks, employ more than 700,000 Americans and are the only physical banking presence in one in three U.S. counties. Holding more than $5.7 trillion in assets, over $4.7 trillion in deposits, and more than $3.6 trillion in loans to consumers, small businesses and the agricultural community, community banks channel local deposits into the Main Streets and neighborhoods they serve, spurring job creation, fostering innovation and fueling their customers' dreams in communities throughout America. For more information, visit ICBA's website at **www.icba.org**.

### CONTINUE THE CONVERSATION


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