SPEECH

Testimony on Exploring Financial Risks on Banking Posed by Climate Change

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As prepared for delivery

Chair Sanders, Ranking Member Borrello, Chair Krueger, Ranking Member O'Mara, Chair Kaminsky, Ranking Member Stec, and members of the Committees, thank you for this opportunity to testify about how the Federal Reserve Bank of New York ("New York Fed") is addressing potential climate-related financial risks to the banking industry. It is a privilege to testify alongside Nina Chen from the New York State Department of Financial Services. Nina is an outstanding partner in prudential supervision. Please permit me to thank Nina and her colleagues publicly for their collaboration.

Before continuing, I am required to state that any opinions I express are my own, not necessarily those of the New York Fed, where I work, or any part of the Federal Reserve System ("Federal Reserve").[1]

The focus of my testimony today will be how climate-related financial risks factor into the supervision of financial institutions, which the New York Fed performs under authority delegated by the Board of Governors of the Federal Reserve System ("Board"). I would like to emphasize that any policy decisions regarding supervision, including about how the Federal Reserve will address-climate related risks, ultimately would be made by policymakers at the Board.

The Federal Reserve "supervises financial institutions to ensure that they operate safely. In addition, the Federal Reserve monitors the financial system as a whole by identifying and analyzing potential risks to financial institutions, the broader financial system, and the economy."[2] And, once material risks and vulnerabilities are identified, the Federal Reserve works to ensure that supervised financial institutions and the financial system are resilient to those risks.

Climate-related financial risks generally fall into two categories: *physical risks* and *transition risks*.

Physical risks are the direct consequences of more frequent instances of severe weather and other climate shifts. For example, the losses from the physical manifestations of climate change could impact homeowners' ability or willingness to continue making mortgage payments to their lenders and tax payments to state and local municipal governments, which then could result in losses for bank lenders and municipal bond holders.

Transition risks are the consequences—both direct and indirect—of changes necessary to limit climate change. Transition risks can arise from changes in consumer and investor preferences, new technology, or changes to governing law. For example, if consumers develop preferences for "green" products and a company fails to foresee this change in demand, the company may suffer financially. This, in turn, could create financial or market risk for supervised financial institutions that lend to that company or hold or underwrite its securities.

Evaluating how these physical and transition risks translate into what we consider "traditional" banking risks—such as credit, market, liquidity, and operational risks—is not an easy task. Climate change occurs over a long time horizon. We lack historical data on which to build analytical models. And we work in a global economy, which amplifies these complexities many times over.

That said, both physical risks and transition risks have the potential to affect communities and industries across New York State, including the financial sector. A recent review of literature by New York Fed economists informs us that the impact of physical and transition risks may be uneven across location, income, race, and age. Moreover, measures that individuals and governments take to adapt to climate change could increase inequality.[3] These risks to local industries and communities—in short, to New York's economy—can also translate into risks for banks. The Board has organized several committees, in coordination with colleagues across the Federal Reserve System, to assess and monitor the financial risks around climate change.

Before concluding, I would like to offer two observations. *First*, the Federal Reserve's work on climate change is important, but limited to our existing mandates—particularly those related to the supervision and regulation of financial institutions and the stability of the broader financial system.

Second, while economic changes as a result of changing consumer and investor preferences, technological developments, and governmental policies present potential risks for the financial sector, they also present opportunities. For example, financial institutions are responding to investor demand for financial products that encompass environmental, social, and governance considerations—more commonly known as ESG investments. There are also opportunities for collaboration between the private and official sectors, which will promote a better-informed response to climate change. Today's hearing is a good example of that.

Again, thank you for the invitation to testify. I would be happy to answer any questions.

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[1] The New York Fed is one of twelve regional Federal Reserve Banks established pursuant to the Federal Reserve Act of 1913. 12 U.S.C. §§ 221 *et seq*. Together with the Board of Governors of the Federal Reserve System and the Federal Open Market Committee, the twelve Federal Reserve Banks make up the Federal Reserve System, the nation's central bank. Pursuant to authority delegated by the Board of Governors, the New York Fed supervises numerous financial institutions located within the Second District of the Federal Reserve System, which includes New York State.

[2] Board of Governors of the Federal Reserve System, *The Fed Explained: What the Central Bank Does*, 63 (11th ed.).

[3] Ruchi Avtar, Kristian Blickle, Rajashri Chakrabarti, Janavi Janakiraman, and Maxim Pinkovskiy, "Understanding the Linkages between Climate Change and Inequality in the United States," Federal Reserve Bank of New York Staff Reports, no. 991 (Nov. 2021).