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New York State Department of Financial Services Finalizes Climate Risk Management Guidance

*By Matthew Bisanz, Justin Herring, Kris D. Kully, Tori K. Shinohara and Jeffrey P. Taft**

This article provides background on the New York Department of Financial Services' climate risk management initiative and discusses the new guidance on how the banks and mortgage institutions it regulates should manage climate-related financial and operational risks.

The New York Department of Financial Services (NYDFS) finalized guidance on how the banks and mortgage institutions it regulates (New York Institutions) should manage climate-related financial and operational risks (the Guidance").[1] The Guidance establishes extensive obligations for New York Institutions, which—even if tailored by the state to be proportionate to size and activities—may create a significant burden. This is particularly true for mortgage bankers and mortgage servicers, which, historically, have not been subject to the same prudential standards and risk management expectations as banks.

While the Guidance largely tracks the December 2022 proposed guidance, it includes some significant changes, particularly with respect to operational resilience and the roles of the governing body or board of directors and management.

The Guidance became effective upon issuance, although NYDFS has not established a timeline for implementation at this time. This article provides background on the NYDFS's climate risk management initiative and discusses the Guidance.

BACKGROUND

NYDFS is the primary regulator for many categories of financial institutions that do business in New York, including New York Institutions. As with the

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[1] NYDFS, Governor Hochul Announces Guidance to Manage Climate Risk For New York State-Regulated Banking And Mortgage Institutions (Dec. 21, 2023),https://www.dfs.ny.gov/reports_and_publications/press_releases/pr202312211. New York Institutions include New York-regulated banking organizations, New York-licensed branches and agencies of foreign banking organizations, and New York-regulated mortgage bankers and mortgage servicers.

federal banking regulators, NYDFS is charged with promoting the safety and soundness of New York Institutions.[2] In recent years, safety and soundness principles have been construed as including the establishment of enterprise-wide risk management systems, although the risk management expectations for mortgage bankers and mortgage servicers are not as well-defined or extensive as those for banks. However, this situation may be changing, as evidenced by the release of model state regulatory prudential standards for nonbank mortgage servicers by the Conference of State Bank Supervisors.[3]

In 2020, NYDFS identified climate change as a driver of risk for the financial institutions that it regulates. This is consistent with the focus of other regulators, such as the Federal Housing Finance Agency (FHFA). In October 2020, NYDFS released initial guidance to New York Institutions on how to manage the financial risks from climate change. It seemed likely, however, that NYDFS would revisit that guidance, particularly given federal and international developments. Therefore, it was not a surprise when NYDFS proposed further guidance in December 2022 on managing climate risk at New York Institutions.

FINAL GUIDANCE

The Guidance expands on the 2020 guidance by establishing a comprehensive framework for managing climate-related financial and operational risks. As with guidance from other regulators, the Guidance defines climate-related financial risk as consisting of physical risks and transition risks, and states that New York Institutions should consider the effects of each of these types of risks on their operational resilience and their safety and soundness, as well as the particular consequences these risks may pose to their customers.

The Guidance identifies three themes to climate risk management: (i) physical and transition risk channels that give rise to climate-related financial risks, (ii) the centrality of operational resilience to safety and soundness, and (iii) the requirement to ensure compliance with all applicable consumer-protection considerations—including fair lending—in adapting the risk management frameworks to account for material climate-related financial and operational risks. The Guidance makes clear that the NYDFS expects New York Institutions to minimize and affirmatively mitigate disproportionate impacts on low- and moderate-income communities and communities of color that may violate fair lending laws.

In a change from the proposal, the Guidance elevates operational risk and operational resiliency from being elements of climate-related financial risk to

[2] See, e.g., N.Y. Banking L. §§ 14, 44.

[3] Press Release, CSBS Releases Model State Regulatory Prudential Standards for Nonbank Mortgage Servicers (July 26, 2021).

being top-tier considerations in a New York Institution's response to climate change. While the Guidance does not define operational risk, it states that operational resilience is a New York Institution's ability to deliver operations, including critical operations and core business lines, through a disruption from any hazard. This theme is integrated into every part of the Guidance.

The Guidance clarifies the issue of proportionality (mentioned above) by stating that New York Institutions should take a proportionate approach to the management of climate-related financial risks based on the institution's exposure to climate risk. The guidance notes that New York Institutions vary in many ways, including size, complexity, and lines of business.

The Guidance retains the proposal's structures and describes the components of prudent climate risk management as:

1. *Corporate Governance*: A New York Institution's board or governing body and management should establish and implement a governance framework that will ensure there is a process in place for identifying, measuring, monitoring, and controlling its material financial and operational risks associated with climate change. This includes appropriate strategy and risk oversight activities, as well as enterprise-wide policies and procedures and controls. In a notable change from the proposal, the Guidance clarifies the roles of the board or governing body and management by assigning specific activities to each.
2. *Internal Control Framework*: A New York Institution should incorporate climate-related financial and operational risks into its internal control frameworks across the three lines of defense, to ensure sound, comprehensive, and effective identification, measurement, monitoring, and control of material climate-related financial and operational risks.
3. *Risk Management Process*: A New York Institution should identify, measure, monitor, and control material climate-related financial and operational risks through its existing risk management framework, including through appropriate approaches to mitigate risks. Climate-related financial risk generally should be embedded in an institution's existing risk categories (e.g., as part of credit risk, not a standalone risk).
4. *Data Aggregation and Reporting*: A New York Institution should use processes for risk data aggregation and internal risk reporting that are sufficient for its risk management needs and able to produce timely information to facilitate governing body or board and senior management decision-making. This represents a modest toning down of the

proposal's expectation that all New York Institutions would develop data aggregation and reporting capabilities.

5. *Scenario Analysis*: A New York Institution should consider using a range of climate scenarios based on assumptions regarding the impact of climate-related financial and operational risks over different time horizons for a variety of risk management purposes. While the Guidance is slightly less prescriptive than the proposal, this expectation may come as a surprise to mortgage bankers and mortgage servicers, which, historically, have not been expected to conduct scenario analysis or stress testing as part of risk management.

IMPLEMENTATION

The Guidance includes a new section on implementation. While the Guidance does not set an implementation timeline, NYDFS will request information from New York Institutions during 2024 on their progress and plans to assess and manage their climate-related financial and operational risks. NYDFS will ask about governance structures, business strategy and risk management processes, operational resiliency measures, and the metrics or targets. The agency will not make individual responses public. However, NYDFS will consider the information collected through this exercise, as well as consultations with the federal banking regulators, when determining appropriate implementation timelines and assessments.

TAKEAWAYS

While the final implementation date is uncertain, New York Institutions should review the changes that will be necessary to comply with the Guidance and start implementing those when possible. Given NYDFS's focus on climate issues, it is likely that they will press for full implementation in late 2024 or 2025. However, for banks that are subject to the Guidance, it appears that NYDFS intends to coordinate with federal banking regulators on implementation, possibly decreasing the imperative to act now.

The Guidance is likely to remain controversial for its statements that New York Institutions "must manage climate-related financial risks prudently while continuing to ensure fair access to capital and credit" and may not implement risk management practices that "unduly harm or disadvantage at-risk communities." While the Guidance states that NYDFS will not dictate credit or investment decisions, the imposition of a fair-access requirement could arguably be viewed as going further than existing fair lending and community reinvestment requirements, if institutions are obligated to make certain products available. This type of supervisory expectation is not common in the United States, and raises a number of potential regulatory and policy concerns.