

How Smaller Banks Can Prepare for Climate-Related Credit Risks

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In 2021 and 2022, the nation's financial regulators began sharing their future expectations for banks related to the growing concern of [climate risk](https://www.bankdirector.com/wp-content/uploads/Managing-Small-Bank-Climate-Risk-Ardmore-11-14-2022.pdf) [\(https://www.bankdirector.com/wp-content/uploads/Managing-Small-Bank-Climate-Risk-Ardmore-11-14-2022.pdf\)](https://www.bankdirector.com/wp-content/uploads/Managing-Small-Bank-Climate-Risk-Ardmore-11-14-2022.pdf).

Their particular emphasis is focused on the impact of climate change on an institution's credit risk. While the near-term direct impact is limited to the country's largest institutions for now, there is an understanding that it's only a matter of time until smaller banks will have to address similar regulatory expectations.

What can, and should, bankers at smaller banks be doing about climate risk in their portfolios? How can they prepare for future regulatory expectations? What information do they need to track?

Bank credit risk managers can start with understanding what types and levels of climate risk they have in their portfolios now, and how to track that going forward. **It's crucial they establish a baseline of their risk appetites and thresholds when looking at emerging risks.**

Banking agencies are looking at rules intended to disclose how larger banks and other firms are incorporating climate risks into their risk management and overall business framework and strategies. That includes physical risks, such as the risk of financial losses from serious weather events like hurricanes and wildfires, and transition risk that come from shifting to a low-carbon economy and creating so-called "orphaned assets."

To understanding a bank's credit and risk exposure to climate sensitive and carbon sensitive assets, credit managers need to start with identifying, flagging and reporting on loans that are either in geographical areas that are more likely to be impacted by physical climate risks and those that are made to higher carbon industries representing potential transition risk.

How To Use Climate Information to Manage Climate Risk

Can smaller banks apply similar methods to manage their climate credit risk that they've used for previously identified emerging risks? Could a bank apply similar approaches it used for commercial real estate and Covid-19 concentrations to identify and track climate concentrations in a loan portfolio to get an overall view of the climate-related credit risk?

A banker could use standard industry codes, also called NAICS Codes, to identify high carbon business or industry concentrations and exposures. Some examples include coal, oil, mining, refining and supporting industries like trucking, drilling and refining, for a few examples.

To address acute climate physical risk a banker could look at using CRE property types like hotels, offices or multifamily for loans in riskier geographic areas like shore and waterways, as well as locations more prone to climate incidents like hurricane, wildfire and floods. There are a few different geo-location codes that can be leveraged for this type of concentration tracking: **zip codes, counties, cities or MSA codes.**

An example of a bank trying to get ahead of coding for climate is \$36.6 billion BankUnited N.A., a regional bank headquartered in Miami Lakes, Florida. The bank's third line of defense assurance group, credit review, wanted to begin broadly identifying climate exposure and climate related borrowers in their portfolios, to advance the consideration of climate impact from a credit perspective.

In 2022, they started by tagging any borrower reviewed by credit review within routine examinations focused on assessing risk grading and underwriting as “carbon sensitive.” The identification is subjective and is based on matters such as the loan borrower’s industry, business operations, inputs or by-products, location and collateral type and related potential repayment risk. Based on those data points, their analyst makes an assessment as to whether or not to tag the loan as “carbon sensitive.” **An example would be a borrower with significant dependence on waterways that are currently experiencing profound and ongoing drought.** They report the results at the examination level, as well as on a consolidated basis to management and the second line of defense.

Currently, there remains no plans for near-term regulatory requirements related to climate change or carbon sensitivity reporting or tracking for community banks. Regulators are only considering the largest banks for rules around climate asset management, climate risk management frameworks and policies.

But risk management techniques are always evolving. Forward-looking risk managers at banks of all sizes will want to continue momentum in 2023, to look forward and create a data-driven climate credit risk management program as tools improve and regulations and industry best practices mature. For now, directionally correct views of climate credit risk can potentially be a strategic risk management advantage for even the smallest bank.



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