*V.*

# State Policy Recommendations for Protecting Against Financial Threats from Climate Change

ling numbers, code adoption lags elsewhere. FEMA's National Preparedness Report from 2023 said that the failure of most states to adopt new building codes that account for climate change is "one of the most significant factors that compounds risk and increases costs from natural hazards." And the 2024 National Preparedness Report noted that as of 2023, 35 states received FEMA's lowest ranking for adoption of hazard resistant building codes.

States that are ready to promote resilient building codes can find resources available from FEMA, including the Building Codes Adoption Playbook, the Building Codes Toolkit for Homeowners and Occupants, and the National Building Code Adoption Tracking Portal, which provides a view of various code adoptions across the nation. Other useful information for regulating building construction or land use can be found from IBHS, the International Code Council (ICC), the HUD, the EPA, and the Association of State Floodplain Managers (ASFPM). States that wish to go beyond code adoption may want to consult ASFPM resources related to No Adverse Impact, a strategy for managing floodplains that aims to improve upon the long outdated rules associated with the NFIP.

## C. STATE BANKING REGULATOR REFORMS

State banking regulators have significant legal authority to reduce climate-related risk to financial institutions, encourage community resilience to disasters, and support transition investment. They also oversee much of the financial system. Their authority covers not only state-chartered banks and savings associations (collectively, banks), but also credit unions and certain other nonbank financial companies.

Federal regulators' backsliding on climate risk creates a dangerous gap that threatens these institutions, households, and the financial system. Even as they shut their eyes to a globally recognized financial risk, Trump appointees are reducing the frequency and intensity of regulatory oversight. The administration has unilaterally curtailed the independence of the federal banking agencies and the NCUA, promised to exempt banks under $100 billion in assets from many regulations, and is proposing to reduce capital requirements that underpin financial system resilience. The administration is also trying to eliminate the Consumer Financial Protection Bureau (CFPB), the only federal regulator with oversight over financial services provided to consumers by nonbanks. Curtailing federal oversight increases the danger of institution failures, consumer harm, and a climate risk-driven financial crisis.

State banking regulators can and should fill the gaps left by this federal withdrawal. The loss of the CFPB's presence has already drawn commitments from states to fill the gap, and state banking regulators should similarly address the federal withdrawal on prudential and other regulatory measures.

State banking regulators have primary oversight over state-chartered banks and credit unions. State examiners supervise those institutions, checking that they operate in a safe and sound manner and follow the law, including consumer protection laws. Banks and credit unions need a charter and must meet requirements set by the chartering agency to get and maintain it, as well as to avoid various enforcement actions. Of the 4,500 insured banks in the US, about 3,500 are chartered by a state banking regulator. These tend to be smaller on average and in aggregate. State-chartered banks hold just over $8 trillion in assets and $6 trillion in deposits, compared to $16 trillion in assets and $11 trillion in deposits at federally chartered banks. However, some large banks have state charters. In contrast, of the roughly 4,400 federally insured credit unions, about 1,600 have a state charter, and federally insured state credit unions account for close to half of all insured credit unions' $2.4 trillion in assets and $2 trillion in deposits.

State banking regulators' oversight goes beyond banks and credit unions. Most also license, regulate and supervise other nonbank financial companies operating in the state, including mortgage and auto lenders and mortgage servicers. Regulators set financial and risk management requirements and examine for compliance with consumer protection law. Because many of these nonbanks operate in all 50 states, one state's decision to set strong financial and risk management requirements can have a nationwide effect.

This scope makes state banking regulators critical regulators for the mortgage market. Fifty-five to sixty percent of loans in the $1.6 trillion residential mortgage market are made by nonbank lenders. Nonbank servicers are a majority of the mortgage servicing market, with responsibility for applying mortgage payments, making property insurance and tax payments, and processing delinquent or defaulted mortgages. Nonbank lenders under state oversight also have a significant share of the auto lending market.

State banking regulators coordinate through the Conference of State Bank Supervisors (CSBS). CSBS administers the Nationwide Multistate Licensing System, which maintains regulatory data for nonbank licensees who operate in multiple states, and supports the State Examination System, which helps coordinate and facilitate exams of companies with a multistate presence. CSBS trains examiners and develops tools they can use to more effectively achieve the goals of supervision.

Connecticut, Illinois, Massachusetts, New York, Rhode Island, Washington, West Virginia, and the District of Columbia have their own Community Reinvestment Acts (CRAs), which state banking regulators administer. State CRAs set expectations for how banks invest in the communities where they do business. Unlike the federal CRA, some state CRAs apply to credit unions and mortgage companies.

State banking regulators have some limits on their authority. They do not oversee national banks or federal savings associations, which are exclusively supervised by the OCC. The OCC can also preempt state laws, rendering them inapplicable to national banks and federal savings associations. The OCC used this authority frequently to block consumer protection laws in the years leading up to the 2008 financial crisis, with disastrous results. While the Dodd-Frank Act put new limits on OCC preemption, the first Trump administration showed little respect for these limits, seeking to preempt actions taken by states to reduce financial burden on communities in response to the COVID pandemic. State banking regulators' authority over federal credit unions is similarly limited.

State banking regulators also may not have a full picture of the climate risks faced by some state banks. State banks may operate as part of bank holding companies, which may own not only a bank, but also other financial businesses, like asset managers and brokers. Regulatory authority over the holding company and its interconnected risks lies with the Federal Reserve. So even where state regulators implement prudent climate risk management requirements, they may find their efforts thwarted by lax federal oversight, as climate risk shifts away from state-regulated companies.

Despite these limitations, state banking regulators still have an opportunity to define market baselines for managing climate-related risk at banks, solve challenging tradeoffs using local knowledge, reduce the overall risk in the financial system, improve disaster resilience, and support high quality transition investment.

LEADERSHIP PROFILE

# Former NY DFS Executive Superintendent, Climate Division, Dr. Yue (Nina) Chen

Dr. Chen is currently Senior Climate Finance Officer at the Office of the NYC Comptroller. During her time at New York Department of Financial Services (NY DFS), Dr. Chen positioned NY DFS as a leader in climate risk management among U.S. financial regulators, state and federal. Under Dr. Chen's leadership, the NY DFS Climate Division issued guidance on climate risk management for insurers, the first state to do so. It also proposed climate risk management guidance for banking and lending organizations, which was finalized after Dr. Chen's departure to join the OCC as its Chief Climate Risk Officer. NY DFS's guidance documents were the first by a U.S. financial regulator to acknowledge that community and regional banks must also manage their climate risk, the first to encourage climate investment in vulnerable areas as part of a resilience strategy, and the first to acknowledge the way the insurance crisis would affect the risk that banks face.

Source: Grantham Research Institute on Climate Change at the Environment at the London School of Economics

NY DFS is one of the largest financial regulators in the world. It regulates the activities of over 1,900 insurers with assets of more than $6.4 trillion and 1,300 banks and financial institutions with assets totaling more than $3.3 trillion. The department's purview ranges from single branch community banks and mutual insurance companies to some of the largest and most sophisticated financial institutions in the world. Early action on climate risk supervision there has set the expectation for banks and insurers operating nationwide and laid out a path for other state banking regulators to follow.

POLICY RECOMMENDATION 1

# Incorporate climate risk into prudential regulation and supervision of financial institutions

State banking regulators should set the expectation that all financial institutions they regulate must appropriately assess and manage their climate risk.

In 2023, the NY DFS did this, issuing guidance to banks and mortgage companies regulated in New York State on management of risks from climate change. That guidance applied to all NY DFS-regulated banks, credit unions, and nonbank mortgage lenders and servicers, regardless of size. NY DFS recognized that smaller banks may be particularly vulnerable to climate or transition shocks, like sea level rise or a rapid change in energy prices, due to their smaller size and reduced diversification.

The NY DFS guidance discusses the financial risks from climate change to financial institutions, focusing on its impact on New York communities; the need to account for tail risks from climate change not well captured by standard risk models; the importance of managing climate risk across an organization, not in silos; and the value of using a longer time horizon than the typical strategic planning cycle. It recommends using scenario analysis to assist with planning for the uncertainty associated with climate change.

In 2021, Washington's Department of Financial Institutions (DFI) asked Washington financial institutions to begin discussions on how to integrate climate into their governance, risk management, and strategic plans. DFI's letter said it would also start talking with institutions about climate-related risks and how to address them in examinations.

State banking regulators should issue detailed guidance like that issued by NY DFS, applying it not just to state chartered banks and credit unions, but also to nonbank mortgage companies and auto lenders. The guidance should reflect the actual risks faced by communities in the state, such as hurricanes, sea level rise, wildfires, or drought, as well as the state economic activities most exposed to transition risk. Climate risk guidance should also address the risks that regulated institutions contribute to, not just the risks that they face individually, and make a precautionary approach the default expectation. State banking regulators should consider how regulated institutions' activities that support fossil fuels contribute to micro and macroprudential risks, and discourage such activities.

As state banking regulators work on issuing guidance, they could send a shorter letter reminding all regulated entities of the ways that climate-related risks can threaten safety and soundness and can start discussions during exams about how regulated entities are thinking about including climate change in their risk management activities.

POLICY RECOMMENDATION 2

## Collect and share climate-related risk data across regulators

State banking regulators need high quality climate data to understand and manage climate risk. They should collect relevant climate-risk related data, share that data across states, and communicate nonconfidential versions to other financial institutions and the broader public.

Today, standardized banking and credit union data is collected via Call Reports. The goal is central, uniform data collection. But if federal regulators refuse to collect climate-risk related data, it creates a uniformly dangerous blind spot. State banking regulators concerned about this blind spot should work together to standardize climate-risk data collection from banks and nonbanks alike and coordinate to minimize collection burdens.

The data collected should include information about mortgages and other loans in high climate risk areas like flood zones or the urban-wildland interface, loan losses in the aftermath of natural disasters, insurance coverage, and lending activity to transition-exposed industries like oil and gas. The Basel Committee on Banking Supervision's climate-related financial risk disclosure framework could be a starting point for identifying and collecting needed information. Preparing and collecting this information will help regulators and financial institutions accurately understand where they face climate risk and the size of potential exposures. Regulators should also publish aggregated data about climate risk exposure, so the public clearly understands the risks faced by banks and the financial system.

POLICY RECOMMENDATION 3

## Develop and share best practices, train staff, and collaboratively support model and scenario development and analysis — and adequately fund these efforts

Properly understanding and managing climate risk will require state banking regulators to train staff in new skills and develop new tools. State regulators should undertake this effort, and coordinate with each other and other regulators to accelerate that process, and states should ensure sufficient funding.

As a first step, state banking regulators should join NGFS, an international group of financial regulators that shares best practices on climate risk management, to build their own technical expertise and benefit from peer experience in implementing climate risk supervision, especially for smaller banks and nonbanks. NGFS supports capacity building and training at regulators and develops climate scenarios to explore a range of plausible climate and transition outcomes. NY DFS has been a member of NGFS since 2019.

State banking regulators should also learn from each other. The easiest path would be to cooperate through CSBS, which has a history of supporting state capacity development, including via development of training and job aids for examiners and its ongoing Catalyst Initiative to help states develop technology solutions to strengthen regulation and supervision. If CSBS is not responsive to this need, state banking regulators should develop other avenues for sharing information, holding trainings, and otherwise supporting professional development for state banking regulators.

Building capacity will mean hiring new staff with expertise in climate, modeling, and software development, and paying for data and software licenses. Most state banking regulators are funded by assessments on regulated entities. They should raise those assessments if necessary to support these investments in reducing future harms to banks from climate change. Where assessment funds must be appropriated, state legislators should approve those appropriations and ask if state banking regulators are spending enough to manage climate risk.

State banking regulators also face a common concern that setting expectations for managing climate risk may be too burdensome and costly for the relatively limited capacity and resources of community banks. Regulators can help address that concern by making the data they license and the tools they build and use available to smaller banks.

State banking regulators can also design standard climate risk models and scenario analysis tools available for use with limited technological investment by small banks, like the public catastrophe models recommended in the insurance section of this report. State banking regulators could also offer small banks something like the stress test of insurer portfolios done by California, Oregon and Washington, also discussed earlier.

**POLICY RECOMMENDATION 4**

## Coordinate with state insurance regulators and other state agencies

Various state agencies likely have information relevant to the climate risks banks face. State banking regulators should obtain and use that data. The NY DFS guidance noted above recognized that rising premiums and insurer withdrawal exposed financial institutions in affected areas to greater losses. If state banking regulators understand the effects of the insurance crisis in their state, they can prioritize their attention on affected banks. If the same agency oversees banking and insurance, like the NY DFS, it should build internal cross-functional teams like the DFS Climate Division. In other states, regulators and legislators should create data sharing agreements and working groups across agencies.

State banking regulators should also coordinate with state agencies tasked with responding to natural disasters. Standardized estimates of the scope of damage and the recovery funds available would help state banking regulators assess the risk of a spike of foreclosures and prioritize their oversight of affected lenders and mortgage servicers appropriately.

POLICY RECOMMENDATION 5

# Ensure servicers treat affected borrowers fairly in the aftermath of a natural disaster

During recoveries from natural disasters, state banking supervisors should pay close supervisory attention to mortgage servicers to make sure they are treating disaster-affected borrowers fairly. After a hurricane, wildfire, or other natural disasters, mortgage delinquencies rise. When Hurricane Harvey made landfall in Houston in 2018, mortgage delinquencies doubled for months afterwards. It will get worse. Borrowers use disaster aid, insurance proceeds, and low-interest-rate Small Business Administration loans to stay current on or pay off mortgages on destroyed properties. As insurance becomes harder to obtain and the Trump administration cuts federal disaster aid and lending programs, more climate-impacted homeowners may fall behind on their mortgage payments.

Servicers have sometimes failed to treat homeowners fairly when delinquency rates rise. Servicing a mortgage that is delinquent or in foreclosure costs a servicer more and requires more attention to detail. Homeowners who fall behind often qualify for forbearance or a modification that gives additional time to make payments but requires more work to administer. Federally insured mortgages administered by the Federal Housing Administration require a 90- day foreclosure moratorium, loan forbearance, and loss mitigation options for borrowers in disaster areas. Fannie Mae and Freddie Mac owned mortgages also provide forbearance and modification options after a disaster.

During the 2008 financial crisis, mortgage servicers lacked the staffing to actually follow legal and contractual requirements like these, and illegally foreclosed on thousands of homeowners by falsifying documents and refusing to work with homeowners facing delinquency. Similarly, a study by the Inspector General of the Federal Housing Finance Agency found that many servicers failed to provide accurate information about pandemic-era mortgage forbearance, as required by law.

State banking regulators should examine whether mortgage servicers have the staff and processes in place to honor legally required protections after a natural disaster. This role is especially important given the decreased presence of the CFPB, which is the only federal regulator of nonbank servicers.

NY DFS's climate risk guidance reflects this expectation and authority. It reminds servicers that they must have resilient processes in place and sufficient staffing to handle rising mortgage delinquencies. Other state banking regulators should issue similar reminders. They should also review foreclosures by servicers during and after natural disasters and require full restitution for errors that unfairly penalize homeowners.

State banking regulators can further protect disaster-stricken communities by encouraging lenders and servicers to work with borrowers beyond the specifics of the mortgage protections after a disaster. They have previously joined federal regulators' post-disaster guidance noting that "efforts to work with borrowers in communities under stress can be consistent with safe-and-sound practices as well as in the public interest." Accordingly, state banking regulators should reassure lenders and servicers that efforts that delay foreclosure will not raise safety and soundness concerns. After the Los Angeles wildfires, the California Department of Financial Protection and Institutions (DFPI) issued guidance that it would not criticize efforts to work with borrowers. Removing this concern can create space for banks to develop additional ways to keep people in their homes after a disaster.

POLICY RECOMMENDATION 6

# Use or expand state level Community Reinvestment Acts to encourage climate resilience and community investment in transition

States can use their CRAs to encourage climate resilience and disaster recovery investments. The federal CRA requires the federal banking regulators to evaluate banks' performance on meeting the credit needs of low- and moderate-income communities where they operate, a first step to reverse the historic legacy of redlining for these communities. In 2023, federal banking regulators modernized the CRA rules, adding language that encouraged banks to meet their obligations by investing in climate resilience and disaster preparedness and recovery. The prior rules already encouraged investing in certain renewable energy, energy efficiency, and electrification projects. In response to bank industry pushback, Trump administration appointees have announced a plan to rescind the modernization. The OCC's efforts to weaken the CRA rules during Trump's first term were thwarted, and this administration may attempt to weaken them again.

Regardless of federal action, states can maintain and expand coverage of their own CRAs to encourage important resilience and recovery investments. In 2021, NY DFS sent a letter to all institutions subject to New York's CRA, laying out the ways that financing renewable energy projects for affordable, community solar projects, microgrids, or flood resilience could all qualify for credit under its CRA. Other state banking regulators with CRA authority can do the same.

In almost all states, legislators should also introduce or expand CRA requirements. Washington and West Virginia's state CRAs do not apply to credit unions and only a handful — Illinois, Massachusetts, and New York, as well as the District of Columbia — cover nonbank and non-credit union mortgage lenders. Because the largest mortgage lenders in the country are often not subject to these state-level CRAs, revisions should be made to ensure that mortgage lenders have a similar obligation to invest in low-and-moderate income communities. State legislators in New Jersey have introduced S4694/A5957, which would extend modernized CRA requirements to banks, credit unions and nonbank lenders wherever they do business.

When legislators implement or expand a CRA, they should use the 2023 federal rules as a baseline and require their regulators to do the same, but they should also consider the harms from financed emissions and support for fossil fuel activities in assigning CRA ratings and impose real consequences for failures to meet CRA obligations. Along with regulators taking supervisory action and considering CRA performance in approving new branches and mergers, states should follow the lead of the District of Columbia and Connecticut and condition the ability to serve as a public depository on CRA ratings.

POLICY RECOMMENDATION 7

## Encourage consistent underwriting and appraisal standards for green improvements to homes

States can also safely encourage green lending by allowing and encouraging financial institutions to recognize the financial benefits of energy efficiency improvements. Lenders often underwrite based on borrowers meeting a certain debt-to-income (DTI) ratio and likelihood of default. Energy efficiency loans help lower energy costs, essentially adding income for borrowers to use to repay the loan. A Freddie Mac study showed that delinquencies for high DTI ratio loans secured by energy-efficient homes were almost half that of similar loans for less efficient homes. A Federal Reserve study found that because EV owners are less exposed to gas price changes, they are less likely to default on their car loans.

But energy efficiency benefits are not consistently underwritten by most lenders. They also are not consistently considered during appraisals in many states, limiting homeowners' ability to recognize the savings. U.S. Senator Michael Bennet and Representative Sean Casten have introduced the Getting Renewable and Energy Efficient Neighborhoods Act (GREEN Act) to establish consistent appraisal standards that recognize energy efficiency features.

State banking regulators can tell regulated lenders that it would not raise concerns to consider home energy efficiency upgrades in underwriting a loan. They can work with appraisal boards to prescribe consistent standards for valuing those upgrades. State legislators can adopt provisions of the GREEN Act, such as standardized values for energy efficient features, additional education on green appraisals, and requiring lenders and appraisers to consider an energy appraisal report when determining the value of a home.

POLICY RECOMMENDATION 8

## Prevent predatory lending tied to consumer investments in resilience and mitigation

States should also make sure that lenders do not take advantage of consumers and small businesses looking to finance energy efficiency and green energy improvements. The trajectory of state Property Assessed Clean Energy Financing (PACE) programs used to fund rooftop solar and efficiency improvements in 19 states is a cautionary tale.

PACE loans can be repaid through a property tax assessment on the borrower's home and are secured by a lien. A 2023 CFPB report on PACE found that these loans increased mortgage delinquency rates and that there were serious issues with the disclosures and promises made by some of the largest program participants.

Even before the CFPB report, California had implemented stricter consumer protections, including disclosures and financial requirements for PACE eligibility. The legislature also gave DFPI a much larger role in licensing and overseeing PACE companies. Florida has also implemented new

consumer protections. In 2024, the CFPB finalized a rule that established nationwide disclosure requirements and ability to repay assessment requirements for PACE financing. With the Trump administration's gutting of the CFPB, only states will be able to enforce this rule. Though the CFPB now asserts that states lack such authority, state banking regulators should work with state attorneys general to ensure that the rule is enforced and should adopt their own regulations to protect borrowers.

As IRA cuts eliminate the federal support for residential investment in clean energy and energy efficiency, states may create new lending programs to fill the gap. PACE programs are an example of how well-intentioned loan programs require appropriate consumer protections, disclosure, and oversight and enforcement. New programs should give examination and licensing authority to state banking regulators, who have experience overseeing lenders.