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Creating a climate of change digest

Climate risk regulatory developments in financial services

Leading off

US financial regulator issues climate risk guidance for large banks, building off recent efforts to encourage bank boards of directors to accelerate their climate-related risk management practices

On December 17, 2021, the Office of the Comptroller of the Currency (OCC) issued much-anticipated draft principles to provide high-level framework guidance for the safe and sound management of exposures to climate-related financial risks for large banks.[1] The OCC notes that "all banks, regardless of size, may have material exposures to climate-related financial risks," but that its draft principles are targeted at the largest banks, those with over $100 billion in total consolidated assets.[2]

Among the principles, the OCC said that bank boards and senior managers should allocate appropriate resources to climate issues and assign climate-related financial risk responsibilities throughout the organization. Banks should also establish processes to identify, measure, and monitor material climate-related risks using exposure analysis, heat maps, climate-risk dashboards, and scenario analysis. The principles further called on banks to consider how climate risks intersect with more well-established risk categories, including credit, liquidity, operational, and litigation risks.

Selected highlights from the OCC's December 2021 issuance[3]

OCC principles for climate-related financial risks

Governance
- Bank's board and management should demonstrate an appropriate understanding of climate-related financial risk exposures and their impact on risk appetite
- A risk governance framework should include:
  - Review of information necessary to oversee the bank
  - Allocation of appropriate resources
  - Assignment of climate-related financial risk responsibilities throughout the organization
  - Clear communication to staff regarding climate-related impacts to the bank's risk profile

Policy, procedure, and limits
- Incorporate climate-related risks into the bank's policies, procedures, and limits
- Policies, procedures, and limits should be modified when necessary to reflect the distinctive characteristics of climate-related risks and changes to the bank's activities

Strategic planning
- Consider climate-related financial risk exposures when setting:
  - Overall business strategy
  - Risk appetite
  - Financial, capital, and operational plans
- Consider climate-related financial risk impact on:
  - Stakeholders' expectations
  - Bank reputation
  - Low-to-moderate income and other disadvantaged households and communities, including physical harm

Risk management
- Oversee the development and implementation of processes to identify, measure, monitor, and control climate-related financial risk exposures within the bank's existing risk management framework
- Incorporate climate-related risks into the bank's internal control frameworks, including internal audit

Data risk measurement and reporting
- Incorporate climate-related financial risk information into the bank's internal reporting, monitoring, and escalation processes to facilitate timely and sound decision-making across the bank
- Ensure effective risk data aggregation and reporting capabilities

Scenario analysis
- Climate-related scenario analysis should:
  - Include a forward-looking assessment of the potential climate risk impact on the bank
  - Be commensurate to the bank's size, complexity, business activity, and risk profile

Management of risk areas	
Credit risk	Monitor climate-related credit risks through sectoral, geographic, and single-name concentration analyses.
Liquidity risk	Determine whether climate-related financial risks could affect liquidity buffers.
Other financial risks	Monitor climate price risk, interest rate risk, and other model inputs for greater volatility or less predictability due to climate-related financial risks.
Operation risk	Consider how climate-related financial risk exposures may adversely impact the bank's operations, control environment, and operational resilience.
Legal and compliance risks	Consider how climate-related financial risks and risk mitigation measures affect the legal and regulatory landscape. Consider possible changes to legal requirements for, or underwriting considerations related to, flood or disaster-related insurance.
Other nonfinancial risks	Consider the extent to which the bank's activities may increase the risk of negative financial impact from reputational damage, liability, or litigation, and implement adequate measures to account for these risks.

The issuance of these principles builds upon a November 8, 2021 speech by Acting Comptroller Michael Hsu in which he posed five questions that bank boards of directors should ask to promote and accelerate improvements in climate risk management practices at their banks.[4]

Hsu noted that by November 2022, "management teams hopefully should be able to answer these questions with greater accuracy and confidence" and that "the journey to get there will require large banks to build up their climate risk management and reporting capabilities."[6]

Acting Comptroller Michael Hsu's speech, "Five Climate Questions Every Bank Board Should Ask"[5]

Five climate questions	
1	"What is our overall exposure to climate change?"
2	"Which counterparties, sectors, or locales warrant our heightened attention and focus?"
3	"How exposed are we to a carbon tax?"
4	"How vulnerable are our data centers and other critical services to extreme weather?"
5	"What can we do to position ourselves to seize opportunities from climate change?"

Related global developments[7]

BCBS climate-risk management principles span the same common building blocks as draft or more formal supervisory expectations set out in the US, EU, UK, and other jurisdictions.

On November 16, 2021, the Basel Committee on Banking Supervision (BCBS), the primary global standard-setter for the prudential regulation of banks, published a consultation paper on principles for the effective management and supervision of climate-related financial risks.[8] The BCBS comment period will close on February 16, 2022.

The BCBS principles span the same common building blocks as draft or more formal supervisory expectations set out in the US, EU, UK, and other jurisdictions—including governance, capital and liquidity adequacy, risk management, scenario analysis, and reporting/disclosures. This issuance confirms that banks will continue to be expected to embed climate risk holistically across all of their operations. It may be possible that a similar approach could potentially be taken for wider environmental risks and (eventually) social risks. In several areas, the BCBS emphasizes the need for an approach proportionate to the size, nature, and complexity of banks' business models—both in the principles for firms and supervisors.

By setting out baseline principles for banks, the BCBS is taking an important step toward establishing a globally consistent approach to climate risk management. This comes at the time of an increasing number of national supervisors setting out their own expectations (or planning to soon). Global consistency will be particularly valuable to internationally active banks. The principles themselves are high level and therefore leave some room for flexibility at the national level, although the detail provided does establish a number of useful standard approaches. Although these principles are still being consulted on, given the strong international supervisory collaboration on climate risk and the alignment of principles with existing frameworks, firms may already want to consider integrating the principles into their existing frameworks.

The chart below compares the recently issued guidance from the BCBS[9] and the OCC.[10]

BCBS and OCC climate-related financial risk guidance comparison

BCBS categories		OCC
Principles for the management of climate-related financial risks		
Corporate governance	• Incorporating climate risks into business strategies and risk management frameworks and assessment of potential impact of climate-related risk drivers • Assigning climate-related responsibilities to members and committees • Implementation of appropriate policies, procedures, and controls	• Appropriate understanding of climate-related financial risk • Effective risk governance framework • OCC guidance considers this under separate principle, "policies, procedure, and controls," outside of governance
Internal controls framework	Incorporate climate-related financial risks into their internal control frameworks across the three lines to ensure sound, comprehensive, and effective identification, measurement, and mitigation of material climate-related finance risks	• OCC covers this under the risk management principle. Management should include corresponding measures of conservatism in their risk measurements and controls
Capital and liquidity adequacy	Identify and quantify climate-related financial risks and incorporate those assessed as material over relevant time horizons into their internal capital and liquidity adequacy assessment process	• Assess if climate risk affects liquidity buffers

BCBS and OCC climate-related financial risk guidance comparison (cont.)

BCBS categories		OCC
Principles for the management of climate-related financial risks (cont.)		
Risk management process	• Identify, monitor, and manage all climate-related financial risks that could materially impair a bank's financial condition, including their capital resources and liquidity positions • Ensure that risk appetite and risk management frameworks consider all material climate-related financial risks to which the banks are exposed • Establish a reliable approach to identifying, measuring, monitoring, and managing risks	• Oversee the development and implementation of processes to identify, measure, monitor, and control climate risk exposures
Management monitoring and reporting	Ensure that internal reporting systems are capable of monitoring material climate-related financial risks and producing timely information to ensure effective board and senior management decision-making	• Bank's internal reporting, monitoring, and escalation processes should include climate risk information
Comprehensive management of credit risk	Understand the impact of climate-related risk drivers on their credit risk profiles, and ensure credit risk management systems and processes consider material climate-related financial risks	• Monitor climate-related credit risks through sectoral, geographic, and single-name concentration analyses
Comprehensive management of market, liquidity, operational, and other risks	Understand the impact of climate-related risk drivers on market risk positions, and ensure that market risk management systems and processes consider material climate-related financial risks	• Monitor the interest rate risk, price risk, and impact on legal and regulatory landscape • Impact on a bank's operations, control environment, and operational resilience
Scenario analysis	• Make use of scenario analysis, including stress testing, to assess the resilience of business models and strategies to a range of plausible climate-related pathways, and determine the impact of climate-related risk drivers on their overall risk profile • Consider physical and transition risks as drivers of credit, market, operational, and liquidity risks over a range of relevant time horizons	• Forward-looking assessment of the potential climate risk impact • Should be commensurate to the bank's size, complexity, business activity, and risk profile
Principles for the supervision of climate-related financial risks		
Prudential regulatory and supervisory requirements for banks	• Comprehensive incorporation of material climate risks into business strategies, corporate governance, and internal control frameworks • Ensure identification, monitoring, and management of climate risks • Incorporate climate-related financial risks into market, liquidity, and operational risk management systems and processes	• Risk-based approach to supervision as per the bank's business model and operational complexity
Responsibilities, powers, and functions of supervisors	• Address material misalignment with appropriate range of techniques and tools, and adopt adequate follow-up measures • Ensure adequate resources and capacity to effectively assess supervised banks • Use climate-related risk scenario analysis, including stress testing to identify relevant risk factors, size portfolio exposures, identify data gaps, and inform the adequacy of risk management approaches	• Risk-based approach to supervision as per the bank's business model and operational complexity

Additional Deloitte perspective on climate risks

For additional insights, please see our ongoing series on how climate risks are shaping US financial regulatory initiatives and the impact these developments may have on the financial services industry and the broader economy.

- ***Deloitte Insights: "Centering around sustainability in financial services firms: Navigating risks, finding opportunities"***
- ***Climate-related financial risk in banking: The state of play on capital requirements***
- ***Addressing the business ramifications of climate risk on banks***
- ***Global foreword to* 2021 financial markets regulatory outlook*, highlighting climate risks in FSI US climate risk***

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Endnotes

1. Office of the Comptroller of the Currency (OCC), "Risk Management: Principles for Climate-Related Financial Risk Management for Large Banks; Request for Feedback," December 16, 2021.
2. Ibid.
3. Ibid.
4. OCC, "Five Climate Questions Every Bank Board Should Ask," November 8, 2021.
5. Ibid.
6. Ibid.
7. Please note: The US and global regulatory developments highlighted in the newsletter are not exhaustive of all activities occurring between late October and early November 2021 but rather are a representative sampling of them.
8. Basel Committee on Banking Supervision (BCBS), "Principles for the effective management and supervision of climate-related financial risks," November 16, 2021.
9. Ibid.
10. OCC, "Risk Management."

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