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Creating a climate of change digest

Creating a climate of change digest: Climate risk regulatory developments in the financial services industry

According to a June 15, 2022, Bank for International Settlements press release, the Basel Committee on Banking Supervision (BCBS) released a set of 18 principles for the supervision and risk management of climate-related financial risk.[1] These *Principles for the effective management and supervision of climate-related financial risks* (Principles) are the latest and broadest articulation of what global banking regulators should consider when seeking to navigate climate-related risks in a holistic and coordinated manner.[2]

The Principles should allow for consistent application across jurisdictions as well as tailoring, where needed, to align with key characteristics of banks (e.g., size, complexity, and risk profile) on a firm-specific or sector-wide basis.[3] The Principles are final and, to the extent possible, banks and supervisors are expected to put them into practice right away. The BCBS intends to follow up with its members to assess relative implementation stages and to ensure both a uniform comprehension of "supervisory expectations" and the formation of coordinated "practices" on an international basis.[4]

In particular, the principles are bifurcated into risk management (consisting of 12 principles for banks) and supervisory focus areas (including six principles for supervisors).

Key risk management themes relate to:

- Corporate governance
- Internal control framework
- Capital and liquidity adequacy
- Risk management process
- Management monitoring and reporting
- Comprehensive management of credit risk
- Comprehensive management of market, liquidity, operational, and other risks
- Scenario analysis

Supervisory principles cover two topics:

- Prudential regulatory and supervisory requirements for banks
- Responsibilities, powers, and functions of supervisors

BCBS Principles for the effective management of climate-related financial risks[5]

Corporate governance	
Principle 1	**Banks should:** • Develop and implement a sound process for understanding and assessing potential impacts of climate-related risk drivers on businesses and on operating environments. • Consider material climate-related financial risks that could appear over various time horizons and incorporate these risks into overall business strategies and risk management frameworks.
Principle 2	**The board and senior management should:** • Clearly assign climate-related responsibilities to members and/or committees and exercise effective oversight of climate-related financial risks. • Identify responsibilities for climate-related risk management throughout the organizational structure.
Principle 3	**Banks should:** • Adopt appropriate policies, procedures, and controls that are implemented across the entire organization to ensure effective management of climate-related financial risks.

Internal control framework	
Principle 4	**Banks should:** • Incorporate climate-related financial risks into internal control frameworks across the three lines of defense to ensure sound, comprehensive, and effective identification, measurement, and mitigation of material climate-related financial risks.
Capital and liquidity adequacy	
Principle 5	**Banks should:** • Identify and quantify climate-related financial risks, and incorporate those risks assessed as material over relevant time horizons into internal capital and liquidity adequacy assessment processes, including stress-testing programs, where appropriate.
Risk management process	
Principle 6	**Banks should:** • Identify, monitor, and manage all climate-related financial risks that could materially impair the entity's financial condition, including capital adequacy and liquidity positions. • Ensure risk appetite and risk management frameworks consider all material climate-related financial risks to which they are exposed, and establish a reliable approach to identifying, measuring, monitoring, and managing those risks.
Management monitoring and reporting	
Principle 7	**Banks should:** • Ensure that risk data aggregation capabilities and internal risk reporting practices account for climate-related financial risks. • Seek to 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.
Comprehensive management of credit risk	
Principle 8	**Banks should:** • Understand the impact of climate-related risk drivers on their credit risk profiles, and ensure that credit risk management systems and processes consider material climate-related financial risks.
Comprehensive management of market, liquidity, operational, and other risks	
Principle 9	**Banks should:** • Understand the impact of climate-related risk drivers on their market risk positions, and ensure that market risk management systems and processes consider material climate-related financial risks.
Principle 10	**Banks should:** • Understand the impact of climate-related risk drivers on their liquidity risk profiles, and ensure that liquidity risk management systems and processes consider material climate-related financial risks.
Principle 11	**Banks should:** • Understand the impact of climate-related risk drivers on operational risk, and ensure that risk management systems and processes consider material climate-related risks. • Understand the impact of climate-related risk drivers on other risks, and put in place adequate measures to account for these risks, where material: – This includes climate-related risk drivers that might lead to increasing strategic, reputational, and regulatory compliance risk, as well as liability costs associated with climate-sensitive investments and businesses.

Scenario analysis	
Principle 12	**Where appropriate, banks should:** • Make use of scenario analysis 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 the overall risk profile. – These analyses should consider physical and transition risks as drivers of credit, market, operational, and liquidity risks over a range of relevant time horizons.

BCBS Principles for the supervision of climate-related financial risks

Prudential regulatory and supervisory requirements for banks	
Principle 13	**Supervisors should:** • Determine that banks' incorporation of material climate-related financial risks into their business strategies, corporate governance, and internal control frameworks is sound and comprehensive.
Principle 14	**Supervisors should:** • Determine that banks can adequately identify, monitor, and manage all material climate-related financial risks as part of their assessments of banks' risk appetite and risk management frameworks.
Principle 15	**Supervisors should:** • Determine the extent to which banks regularly identify and assess the impact of climate-related risk drivers on their risk profile, and ensure that material climate-related financial risks are adequately considered in their management of credit, market, liquidity, operational, and other types of risk. • Determine that, where appropriate, banks apply climate scenario analysis.
Responsibilities, powers, and functions of supervisors	
Principle 16	**Supervisors should:** • Utilize an appropriate range of techniques and tools and adopt adequate follow-up measures in case of material misalignment with supervisory expectations, in conducting supervisory assessments of banks' management of climate-related financial risks.
Principle 17	**Supervisors should:** • Ensure adequate resources and capacity to effectively assess banks' management of climate-related financial risks.
Principle 18	**Supervisors should:** • Consider using climate-related risk scenario analysis to identify relevant risk factors, size portfolio exposures, identify data gaps, and inform the adequacy of risk management approaches. • Consider the use of climate-related stress testing to evaluate a firm's financial position under severe but plausible scenarios. • Consider, where appropriate, disclosing the findings of scenario analysis and stress-testing exercises.

Key takeaways

The Principles represent the BCBS's latest indication that global banking regulators are focused on existing and emerging climate-related financial risks, presented to individual banks as well as the banking system as a whole. The Principles also provide insight on the ways in which matters related to climate-related financial risks may be addressed by both banks and banking regulators, with a substantial focus on risk management and sound corporate governance.

From a US perspective, the BCBS principles are similar to those proposed principles issued for comment by the Office of the Comptroller of the Currency (OCC) on December 17, 2021, and Federal Deposit Insurance Corporation (FDIC) on March 30, 2022.[6] Specifically, the BCBS, FDIC, and OCC principles share the view that all banks should be aware of climate-related risks, with the initial set of principles being applicable to large banks. Many of the principles articulated by the BCBS are not new and overlap or correspond with those of the OCC and the FDIC.

On June 21, 2022, the Council of the European Union (Council) issued a press release outlining a "provisional political agreement" involving the Council and the European Parliament and concerning the corporate sustainability reporting directive (CSRD).[7] The CSRD calls for comprehensive reporting on environmental, social, and governance (ESG) matters and could likely have a meaningful impact on non-European countries with sizable business operations in the European Union.

Specifically, the requirements described below for non-European businesses span four areas (applicability, reporting, assurance, and accessibility) and point toward distinct responsibilities that may capture the attention of such firms.[8]

Applicability:

- Businesses not established in the EU but with securities listed on regulated markets should disclose information on sustainability matters.
- Third-country businesses with significant activities in the EU should provide sustainability information, especially on their impact regarding social and environmental matters:
  - Third-country businesses that generate a net turnover of more than EUR 150 million in the EU and have a subsidiary or a branch in the EU should be subject to EU sustainability reporting requirements.
  - Additional thresholds are applied on branches (net turnover of EUR 40 million in the EU) and subsidiaries (they must be large or listed subsidiaries) that should be responsible for publishing the sustainability report of the third-country business.

Reporting:

- The sustainability reports published by the subsidiary or branch of the third-country business should be prepared according to standards to be adopted by June 30, 2024, by the European Commission (Commission) through delegated acts.
  - Businesses can also report according to the standards applying to EU businesses, or according to standards that are deemed equivalent according to the Commission's decision.
- If the required information is not provided by the third-country business, the subsidiary or branch should provide all the information in its possession and a statement indicating that the third-country business did not make the rest of the required information available.

Assurance:

- The sustainability reports of third-country businesses should be published with an assurance opinion (by a person or firm authorized to give an opinion on the assurance of sustainability reporting).
- If an assurance opinion was not provided, the subsidiary or branch should issue a statement indicating that the third-country business did not provide the necessary assurance opinion.

Accessibility:

- The sustainability report should be made accessible and free of charge to the public.
- Member States may inform the Commission on an annual basis of the subsidiaries or branches of third-country businesses that fulfilled the publication requirement and of the cases where a report was published but the branch or subsidiary stated it could not get the necessary information from the third-country business.
- The Commission shall publish a list of third-country businesses that publish a sustainability report on its website.

On June 23, 2022, the OCC published the Spring 2022 *Semiannual risk perspective*, which highlights climate-related financial risks to banks' safety and soundness and the OCC's recent activities on this emerging area of risk.[9]

The report recaps the OCC's recent climate-related activities, including the publication of draft "Principles for Climate-Related Financial Risk Management for Large Banks" for feedback and the OCC's engagement with other agencies on climate-related financial risk, and recent outreach such as hosting of the Symposium on Climate Risk in Banking and Finance in June.[10]

The OCC provided an update on banks' climate risk management frameworks. For large banks, examination teams are integrating climate into supervision. For midsize and community banks, risk management considerations related to products and geographies are in early stages.

Finally, the report calls attention to the heightened compliance risk due to a rise in environmental crimes, associated illicit financial activity, and their effects on climate risk. Environmental crimes, through corruption and transnational criminal organizations, threaten ecosystems, decrease biodiversity, and increase carbon dioxide in the atmosphere. Banks can mitigate these risks through the Bank Secrecy Act, anti-money laundering, and Office of Foreign Assets Control risk assessments, staffing assessments, and long-term planning.

On July 14, 2022, the Financial Stability Board (FSB) published its first annual progress report (Report) on the July 2021 *FSB roadmap for addressing climate-related financial risks* (FSB roadmap).[11] The FSB roadmap's primary purpose is to display a cohesive approach to addressing climate-related financial risk, along with action steps and typical time parameters, and to pinpoint advancements made in four fundamental areas (firm-level disclosures, data, vulnerabilities analysis, and regulatory and supervisory tools).[12]

The Report is structured not only to provide status updates, but also inform related policy fora and organizations (e.g., G2, G7, and the United Nations), with the initial report shared during the July 15, 2022, G20 Finance Ministers and Central Bank Governors meeting in Bali, Indonesia.[13] The Report features the following recent roadmap developments:[14]

- **Firm-level disclosures:** The International Sustainability Standards Board published two reports outlining standards for climate and sustainability-related disclosures.
- **Data:** Work is ongoing to enhance climate-related data accessibility and quality from an international perspective.
- **Vulnerabilities analysis:** Continuous monitoring, the expansion of theoretical frameworks, and the improvement of scenario analysis and stress-testing techniques have all taken place.
- **Regulatory and supervisory practices and tools:** The drafting of supervisory guidance specific to the banking, insurance, and asset management sectors is in varying stages of completion across jurisdictions.

The Report emphasizes the need for cross-border cooperation and coordination to effectively address climate-related financial risks going forward. The FSB intends to continue publishing its annual progress reports to inform a wide range of stakeholders of international progress in the policy development and implementation space.

The Commodity Futures Trading Commission (CFTC), via a July 18, 2022, press release, announced its decision to extend the comment period for a Request for Information (RFI) on Climate-Related Financial Risk.[15] We previously highlighted the RFI in our July edition of this newsletter.[16]

The RFI was initiated on June 2, 2022, with a 60-day comment period ending on August 8, 2022. The purpose of the RFI is to solicit information that would inform the agency's views and policy initiatives on climate-related financial risk and more specifically, "seek responses on questions specific to data, scenario analysis and stress testing, risk management, disclosure, product innovation, voluntary carbon markets, digital assets, greenwashing, financially vulnerable communities, and public-private partnerships and engagement."[17] However, the agency's July 18 press release, as noted above, effectively extended the comment period from the initial August 8, 2022, close date to October 7, 2022.[18] The press release communicates the agency's rationale for extending, noting that the number and nature of topics addressed in the RFI suggests that those interested in submitting a public comment may benefit from additional time to do so.

Additional Deloitte US 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:

- ***Centering around sustainability in financial services firms: Navigating risks, finding opportunities***
- ***Ingraining sustainability in the next era of ESG investing***
- ***Addressing the business ramifications of climate risk on banks***
- ***Building a more sustainable insurance industry***

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Endnotes

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11 Financial Stability Board (FSB), *FSB roadmap for addressing climate-related financial risks*, July 7, 2021; FSB, "FSB outlines progress made on addressing financial risks from climate change," press release, July 14, 2022.

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14 FSB, "FSB outlines progress made on addressing financial risks from climate change," press release, July 14, 2022.

15 Commodity Futures Trading Commission (CFTC), "CFTC extends public comment period on Request for Information on Climate-Related Financial Risk," press release, July 18, 2022; CFTC, "CFTC releases Request for Information on Climate-Related Financial Risk," press release, June 2, 2022.

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