Financial institutions and climate change: OSFI Guidance on climate risk management

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What you need to know

The Office of the Superintendent of Financial Institutions (**OSFI**) published a draft guideline (the **Guideline**) on climate risk management on May 26, 2022. The Guideline establishes OSFI's expectations for federally regulated financial institutions (**FRFIs**) regarding the management of climate-related risks, which OSFI broadly categorizes as physical risks and transition risks. See BLG's article on climate finance at COP26 for more information about climate-related risk. The Guideline proposes requiring FRFIs to analyze and publish forward-looking strategies that are holistic, integrated and built on reliable empirical data and analysis, which is a prudent framework to support FRFIs as they develop greater resilience to and management of climate-related risks.

The Guideline refers to the recommendations (the **TCFD Recommendations**) developed by the Task Force on Climate-related Financial Disclosures (**TCFD**), as well as the climate change reporting metrics proposed by the International Sustainability Standards Board (**ISSB**) in its draft climate disclosure standard, which is also currently undergoing public consultation.

In addition to requiring disclosure based on the TCFD Recommendations and the ISSB climate metrics, the Guideline requires FRFIs to use climate scenario analysis to continually:

- inform business strategies
- develop and disclose a climate transition plan
- disclose its net zero commitments, if any

OSFI will be developing a standardized climate scenario analysis exercise to assess aggregate exposures to physical and transition risks and compare FRFI approaches to climate scenario analysis.

FRFIs will be required to apply these scenarios and report their results to OSFI. Regarding disclosure, FRFIs must disclose the information required by the Guideline within 180 days of the fiscal year-end, but have discretion as to where to disclose.

In response to the Guideline, FRFIs need to rethink their strategies and operations through a climate risk lens to ensure regulatory compliance in the near future.

OSFI intends to review and amend the Guideline as practices evolve and standards harmonize. OSFI welcomes public comments on the Guideline before August 19, 2022, and intends to issue a final Guideline by early 2023, along with a non-attributed summary of comments received and OSFI's response to them.

How we got here

In 2019, the Expert Panel on Sustainable Finance underscored the importance of embedding climate-related risk into the monitoring, regulation and supervision of Canada's financial system. In its final report, the panel recommended that the Bank of Canada and OSFI, as applicable, formally integrate climate risk into the supervision of FRFIs and provide clear guidance on related regulatory expectations.

Following the panel's recommendation, the Bank of Canada and OSFI have collectively:

- Committed to disclose climate-related financial risks in monetary policy reports, financial system reviews and other regular reports (November 2021).
- Committed to report on climate-related financial risks in line with the recommendations of TCFD (see our article on the TCFD guidance and reporting framework for details) (November 2021).
- Completed a consultation with FRFIs and federally regulated pension plans, and published *Navigating Uncertainty in Climate Change* (we provide details on the consultation in another article) (October 2021).
- Completed a pilot project with respect to climate-related risk stress tests (also referred to as scenario analysis) and published *Using Scenario Analysis to Assess Climate Transition Risk* (January 2022).

Expected outcomes

OSFI expects at least three outcomes for FRFIs when implementing the Guideline:

- **Outcome 1**: The FRFI understands and mitigates against potential impacts of climate-related risks to its business model and strategy.
- **Outcome 2**: The FRFI has appropriate governance and risk management practices to manage identified climate-related risks.
- **Outcome 3**: The FRFI remains financially resilient through severe, yet plausible, climate risk scenarios, and operationally resilient through disruption due to climate-related disasters.

Guideline overview

The Guideline has two chapters and five annexes. The first chapter outlines OSFI's expectations on governance; risk management; climate scenario analysis and stress testing; and capital and liquidity adequacy. OSFI has included principles for each of the four categories, along with clarifying remarks on each principle.

Governance	**Principle 1: The FRFI should incorporate the implications of climate change and the transition to a low greenhouse gas (GHG) economy into its business model and strategy.** This includes developing a climate transition plan. **Principle 2: The FRFI should have the appropriate governance, policies and practices in place to manage climate-related risks.** This includes tying senior management compensation to how the institution handles climate-related risks.
Risk management	**Principle 3: The FRFI should have processes in place to adequately price climate risk-sensitive assets and liabilities and manage these exposures in accordance with the FRFI's risk appetite framework.** This includes using reliable, timely, relevant and accurate climate risk data (e.g. GHG emissions data and geophysical location of exposures) to understand the exposure of its portfolio companies. **Principle 4: The FRFI should mitigate the impact of climate-related disasters on its critical operations.** OSFI expects FRFIs to consider severe yet plausible climate-related disaster scenarios in their decision making regarding operations.
Climate scenario analysis and stress testing	**Principle 5: The FRFI should use climate scenario analysis to assess the impact of climate-related risk drivers on its risk profile, business strategy and business model.** OSFI requires the FRFI to regularly include such scenario analysis as part of its overall stress-testing framework. OSFI intends to develop a standardized climate scenario analysis exercise to assess aggregate exposures to physical and transition risks. FRFIs would be required to apply these scenarios and report their results to OSFI.
Capital and liquidity adequacy	**Principle 6: The FRFI should maintain sufficient capital and liquidity buffers for its climate-related risks.** The FRFI should incorporate climate-related risks into its internal capital adequacy assessment process or own risk and solvency assessment process. As part of this process, the FRFI should consider its capital requirements under severe, yet plausible, climate-related scenarios, and climate-related risks that could materialize beyond the FRFI's standard

	capital planning horizon.

Principles of effective disclosure

The TCFD Recommendations outline seven principles for effective disclosure that it expects any entity looking to provide TCFD-compliant disclosure to follow. Disclosures should:

- represent relevant information (TCFD principle 1)
- be specific and complete (TCFD principle 2)
- be clear, balanced and understandable (TCFD principle 3)
- be consistent over time (TCFD principle 4)
- be comparable among companies within a sector, industry or portfolio (TCFD principle 5)
- be reliable, verifiable and objective (TCFD principle 6)
- be provided on a timely basis (TCFD principle 7)

Chapter 2 of the Guideline utilizes the same principles for effective disclosure as the TCFD, with two differences: (1) the Guideline does not include TCFD principle 7, and (2) with respect to TCFD principle 5, the Guideline recommends that the disclosures be appropriate to the FRFI's size, nature and complexity.

Where the rubber hits the road: The annexes

Some of the more prescriptive obligations are outlined in the annexes to the Guideline. In particular, Annex 2-1 states that OSFI's climate risk-related financial information disclosure expectations include:

- Expectations based on the TCFD Recommendations and the ISSB's draft climate disclosure standard with respect to governance, strategy, risk, and metrics and targets (the four pillars of the TCFD Recommendations); GHG emissions; the ISSB's cross-industry metrics (which require the disclosure of Scope 1, Scope 2 and Scope 3 GHG emissions for all entities, regardless of the sector in which they operate); and the ISSB's industry-specific metrics for banks and insurers;
- A climate transition plan; and
- Net zero commitments, if the FRFI has made one or more.

Annex 2-2 sets out the minimum climate-related financial risk disclosure expectations by FRFI category. Regarding GHG emissions, it is only Category 2 and Category 3 small and medium-sized deposit-taking institutions, as well as all other federally regulated insurers, that are exempt from reporting Scope 3 emissions. The FRFI is expected to use the Partnership for Carbon Accounting Financials' *Global GHG Accounting and Reporting Standard for the Financial Industry* or a comparable industry standard (if any) to disclose Scope 3 emissions associated with the FRFI's loans and investments.

BLG will continue to monitor transitions led by the financial sector in Canada, as well as international consultations on climate-related risks. Please contact the authors or other key personnel if you have any questions about the OSFI draft Guideline or the related consultation.

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