FSB releases its final report on climate-related financial risk

October 19, 2022

On October 13, 2022, the Financial Stability Board (FSB) released its final report for supervisors and regulators titled *Supervisory and Regulatory Approaches to Climate-related Risks* (the Report).

What you need to know

- The Report offers:
  - a snapshot of various efforts taken to date by supervisory and regulatory authorities across the globe (including the Bank of Canada and the Office of the Superintendent of Financial Institutions (OSFI)) to assess and manage climate-related financial risk; and
  - recommendations for such authorities to further refine their review and management of climate-related financial risk.
- The Report was supported by a public consultation whereby the FSB received 27 written responses from a variety of stakeholders across the global financial markets, including associations that support the financial sector in Canada.
- The FSB has updated the status of certain objectives and timelines in its annual roadmap.

The FSB report and consultation

Earlier this year, the FSB published an interim report to assist supervisory and regulatory authorities with their approaches to monitor, manage and mitigate financial risks that may arise from climate change, and to promote uniformity across sectors and jurisdictions. Following a public consultation, the FSB released the Report, which includes recommendations to support the following:

1. supervisory and regulatory reporting and collection of climate-related data from financial institutions; and
2. system-wide supervisory and regulatory approaches and the extent to which supervisory and regulatory tools and policies address climate-related financial risk.

An overview of responses from the consultation that accompanied the Report summarizes the responses received from various stakeholders regarding the interim report, and reiterates the scope of the FSB's mandate (*i.e.* understanding the financial risks of climate change vis-à-vis how the financial sector affects climate change). The FSB hopes that a global approach to addressing climate-related financial risk will help to better assess and mitigate financial vulnerabilities and reduce the inefficiencies of market fragmentation.

This article shares key findings and recommendations from the Report, as well as expected developments to sustainable finance in Canada.

Reporting and data collection

Supervisory and regulatory authorities have noted the lack of sufficiently consistent, comparable, granular and reliable climate data. The Report encourages such authorities to accelerate the identification of their data needs and provide key policy considerations to facilitate standardised regulatory reporting requirements. Specifically, supervisory and regulatory authorities are encouraged to clearly communicate their expectations of financial institutions' governance, processes and controls on climate-related data reported.

On May 26, 2022, OSFI published a draft guideline (the OSFI Guideline) on climate risk management, which we outline in our previous article. The OSFI Guideline establishes OSFI's expectations for federally regulated financial institutions to manage climate-related financial risks, which OSFI broadly categorizes as physical risks and transition risks. A final guideline is expected in early 2023, which will likely be influenced by the recommendations set forth in the Report.

While some supervisory and regulatory authorities classify litigation risk as a sub-category of physical and transition risks, the FSB suggests that liability risk might materialise independently from transition risks and far in advance from the materialisation of both transition and physical risks. Litigation and regulatory investigations with respect to greenwashing and other concerns are growing as of late.

The FSB also notes that where appropriate within jurisdictions' legal and regulatory frameworks, supervisory and regulatory authorities should consider the need for third-party verification to strengthen the reliability of climate-related data. According to the FSB, third-party verifications could play an important role also in avoiding greenwashing risks.

Furthermore, the Report offers a summary of the qualitative and quantitative information that financial supervisory and regulatory authorities are collecting in various jurisdictions globally (see Annex 1 of the Report). Such supervisory and regulatory authorities are working to collect the following information and more from financial institutions:

1. climate and/or diversity focused governance structures;
2. risk reduction measures to identify, assess and manage climate related financial risk;
3. strategic decisions, such as a financial institution's decarbonization pathway;

4. financial metrics for portfolio exposure by sector or economic activity to carbon sensitive sectors;
5. average term of exposures; and
6. geographical location of assets at a granular level.

Standardizing tools for assessing climate-related financial risks

Based on its review, the FSB notes that the incorporation of climate-related risks into risk management practices across financial institutions is in the early stages. Nonetheless, supervisory and regulatory authorities in some jurisdictions expect financial institutions to include ESG considerations within their risk management procedures. One example is the European Union where large listed banks are subject to mandatory disclosure requirements.

Another objective of the FSB (and the Network of Central Banks and Supervisors for Greening the Financial System) is to assist with the design and use of climate scenario analysis and stress tests for macroprudential purposes. The Report details specifics of the recent pilot project by the Bank of Canada and OSFI, which we also discuss in our previous article.[1]

According to the FSB, when seeking to adopt a "system-wide perspective", emerging practices include the use of top-down exercises combined with bottom-up elements involving financial institutions, dynamic balance sheet assumptions, and common scenarios. In the FSB's view, the design and scope of the analysis should ideally include the following features to inform a system-wide view:

- both physical and transition risks[2];
- key financial sectors;
- interdependencies between physical and transition risks, geographical and sectoral risks, as well as improved understanding of impacts on financial risks; and
- system-wide aspects of climate-related risks such as indirect exposures, risk transfers, spillovers and feedback loops.

Going forward, the FSB wants future scenario analysis and stress testing exercises to consider financial risks beyond credit and market risks (e.g. liquidity and insurance (underwriting) risks)) and whether such may pose any material risks to the market.

What's next?

In Canada, stay tuned for the following:

- The recently formed Sustainable Finance Action Council is expected to publish a taxonomy for sustainable finance instruments later this year.
- An implementation committee is currently in the process of forming the Canadian Sustainability Standards Board, which is expected to be operational by April 1, 2023 to domesticate the forthcoming minimum disclosure standards of the International Sustainability Standards Board.

- The Bank of Canada and OSFI expect to refine and expand scenario analysis and stress testing exercises for climate-related financial risk.
- OSFI plans to finalize its guidelines for federally regulated financial institutions in early 2023 following the completion of its consultation.

For any questions, please consult any of the key contacts listed below.

[1] Please note that the Basel Committee on Banking Supervision has since published its final principles for the effective management and supervision of climate-related financial risks after completing its own consultation period.

[2] The Bank of Canada and OSFI expect to expand their scenario analysis to understand physical risks.

By

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