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A LOOK AT CANADA'S CLIMATE RISK MANAGEMENT GUIDELINES

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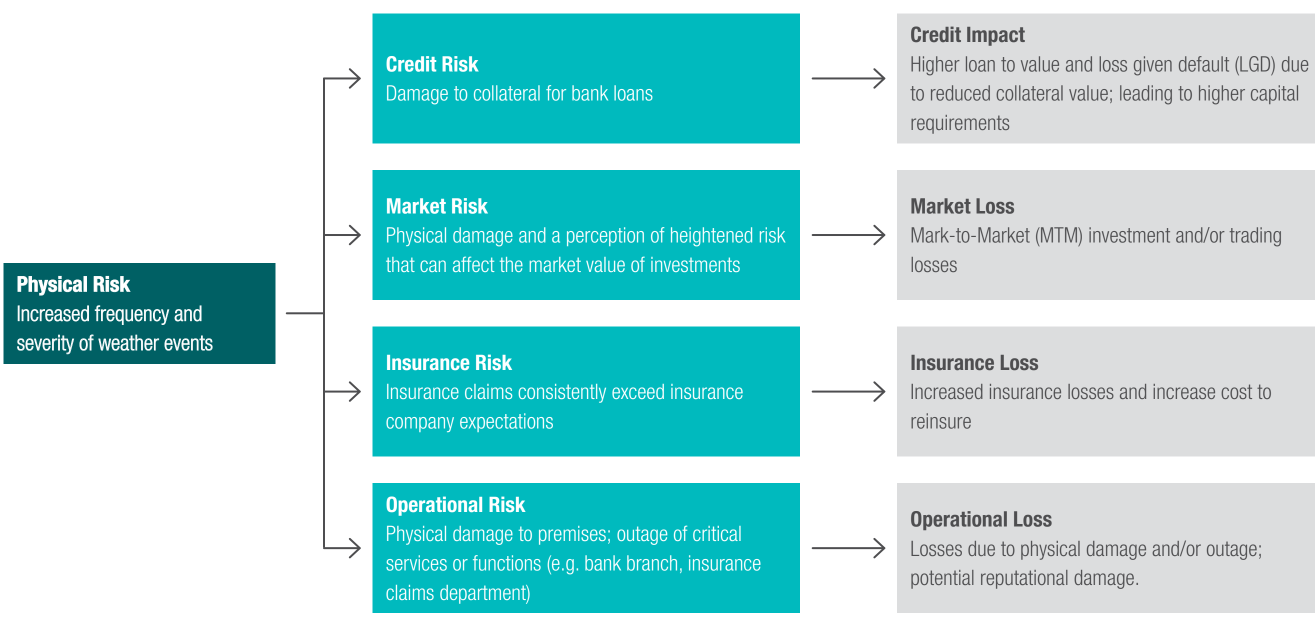
INTRODUCTION

Banks and insurance companies are not immune from the effects and associated response toward the growing awareness of addressing climate change. Based on the critical role financial institutions play in the global economy, their complex operations reach across affected industries and global boundaries. Federal regulators around the world constantly need to balance the emerging trends of addressing climate-related risks with a responsibility to manage “the safety and soundness of the financial system” on behalf of the citizens in their jurisdiction. In the case of Canada, the Office of the Superintendent of Financial Institutions (OSFI) recently released a draft guideline, B-15: Climate Risk Management, to help address climate related risks in financial services.

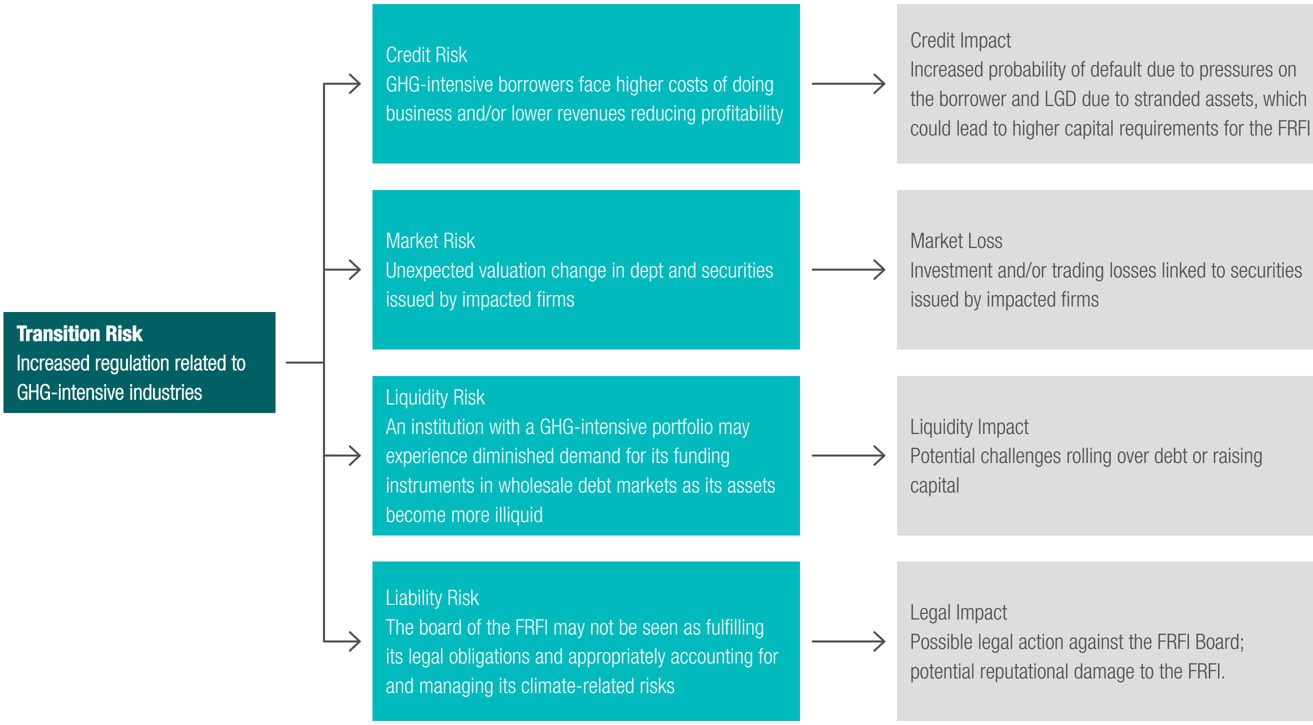
OSFI categorizes “climate-related risks” into two broad groupings:

- **Physical Risks:** the financial risks from the increasing severity and frequency of extreme climate change-related weather events (i.e., acute physical risk); longer-term gradual shifts of the climate (i.e., chronic physical risks); and indirect effects of climate change such as public health implications (e.g., morbidity and mortality impacts).

- **Transition Risks:** the financial risks related to the process of adjustment towards a low-greenhouse gas (GHG) economy. These risks can emerge from current or future government policies, legislation. And regulation to limit GHG emissions. As well as technological advancements, and changes in market and customer sentiment towards a low-GHG economy.



Physical Risk – OSFI B-15: Climate Risk Management



Transition Risk – OSFI B-15: Climate Risk Management

With a holistic view, OSFI is working with Federally Regulated Financial Institutions (FRFI) to support the integration of climate-related risks into their ongoing operations and risk management practices. This entails charting an objective path to incorporate financial risks (credit, market, insurance, and liquidity), in addition to strategic, operational, and reputational risks. The importance of providing rigour and transparency of managing risk at this early stage of transition is an important step in maintaining confidence and resilience, particularly in the event of severe instances of "climate-related risks that can threaten the long-term viability of an FRFI's business model."

Canada's climate risk management guidelines focus on providing principles-based expectations for "improvements in the quality of the FRFI's governance and risk management practices" with three anticipated outcomes:

1. The FRFI understands and mitigates against potential impacts of climate-related risks to its business model and strategy.

2. The FRFI has appropriate governance and risk management practices to manage identified climate-related risks.

3. The FRFI remains financially resilient through severe, yet plausible, climate risk scenarios, and operationally resilient through disruption due to climate-related disasters.

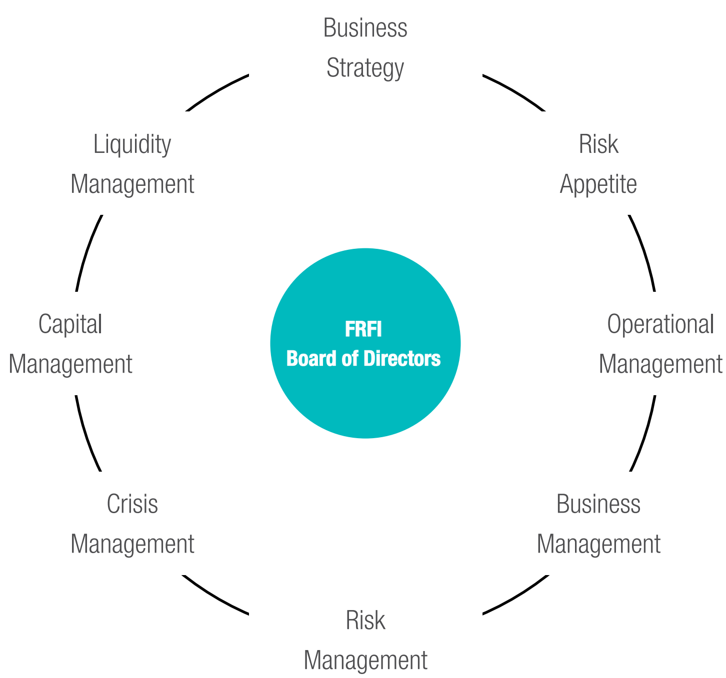
CORE COMPONENTS OF CANADA'S CLIMATE RISK MANAGEMENT GUIDELINES

Canada's Climate Risk Management guidelines are divided into two chapters: 1) Governance and Risk Management Expectations; and 2) Climate-Related Financial Disclosure.

CHAPTER 1: GOVERNANCE AND RISK MANAGEMENT EXPECTATIONS

Governance

Incorporating "the implications of climate change and the transition to a low greenhouse gas (GHG) economy to the FRFI in its business model and strategy" is an important aspect of adopting the new guidelines, including the development of a Climate Transition Plan. In addition to the renewed accountability and leadership of Senior Management, there is an expectation of integrating climate-related risks into an FRFI's Risk Appetite Framework, Internal Control Framework and overall Enterprise Risk Management. By focusing on the fundamentals of Corporate Governance from the Board of Directors down, the new elements of climate-risk can be integrated into ongoing risk management policies and procedures.



Corporate Governance considerations for a Federally Regulated Financial Institution (FRFI)

Risk Management Expectations

"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."

- Risk Identification, Measurement and Management: "the potential impact of climate-related risk on its portfolio of exposure" needs the appropriate processes and controls in order to collect "reliable, timely and accurate" data. Applicable tools and models are needed to assess the new scenarios, but caution and transparency will be required to ensure confidence in outputs.

- Risk Monitoring and Reporting: In addition to the data that is collected, FRFI's need to integrate internal reporting systems to assess the effectiveness of their risk management.

- Operational Preparedness and Resilience for Climate-Related Disasters: While business continuity plans (BCP) and disaster recovery plans (DRP) have been an integral part of management, the inclusion of extreme (but plausible) weather related events should be considered as part of broader resiliency planning.

- Awareness and Capabilities Building: Ongoing monitoring of the evolving data and internal/external sources will be required to update and tune models, policies and procedures.

Climate Scenario Analysis and Stress Testing

An "FRFI should use climate scenario analysis to assess the impact of climate-related risk drivers on its risk profile, business strategy, and business model." Financial institutions need to begin integrating hypothetical scenario's covering appropriate time horizons, including both physical and transition risks aligned to their business strategy and risk profile. The climate scenario analysis should also be included in a Stress Testing Framework, "to inform its strategic planning and enterprise risk management." As with all analyses, there should be a broad range of scenarios that are both plausible and relevant to their business operations.

Capital and Liquidity Adequacy

A core element of all FRFI's in Canada is the rigour placed on quantifying the coverage of its capital and liquidity buffer to account for adverse events. They need to incorporate climate-related risks into their Internal Capital Adequacy Assessment Process (ICAAP) for banks or Own Risk and Solvency Assessment (ORSA) for insurance companies, considering both plausible and severe scenarios and risks based on their business strategy and market circumstances. "For example, the FRFI should consider, among other things, the impact of increased drawdowns of deposit balances and credit/liquidity lines for counterparties sensitive to climate-related risks, volatility in insurance claims experience due to climate change, etc."

CHAPTER 2: CLIMATE-RELATED FINANCIAL DISCLOSURE

Purpose of Disclosure Expectations:

Financial reporting and disclosure is at the heart of OSFI's role in the banking and insurance industry in Canada, helping regulated entities with clearly defined principles-based guidance for their risk management. Climate-related financial disclosure expectations help meet two core objectives:

1. "Helps OSFI meet its mandate of protecting depositors, creditors, and policyholders, and contributing to public confidence in the Canadian financial system, by ensuring appropriate information is publicly available to enable understanding of FRFI's financial condition and the risks to which they are exposed."

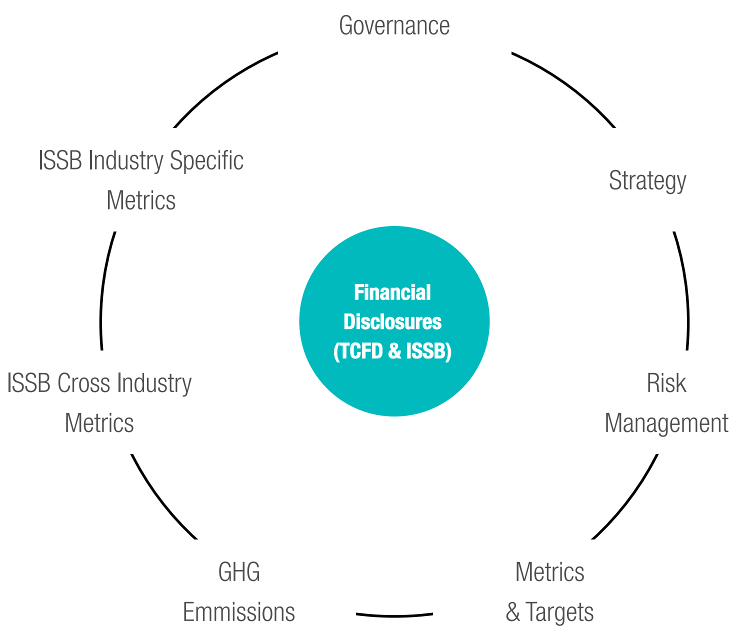
2. Provides a common format of financial and risk related information to various stakeholders in the Canadian financial system, including "investors, analysts and the public at large." By providing this information broadly, there is an expectation of building confidence and resilience in the systems.

Principles for Effective Disclosure of Climate-Related Risks

For the past several years, Canadian FRFI's have voluntarily adopted a variety of climate-related financial disclosures. OSFI's expectation is to leverage Financial Stability Board's Task Force on Climate-Related Financial Disclosure (TCFD) Framework and the International Sustainability Standards Board's (ISSB) Exposure Draft on Climate Related Disclosure. As with all reporting, financial institutions are expected to find a reasonable balance between providing relevant, high-quality information and the ability to source and provide that information. OSFI has established six initial principles to guide financial disclosure, emphasising that information should be:

- Relevant
- Specific and complete
- Clear, balanced and understandable
- Reliable, verifiable and objective
- Appropriate for its size, nature and complexity
- Consistent over time

The implementation of the new financial disclosures in Canada are targeted for fiscal periods ending on or after Oct. 1, 2023, with a prescribed roadmap of expectations over several years, with the final phase of updates slated for 2027. The initial components will focus on elements from the TCFD and ISSB frameworks, reported on an annual basis.



Initial Disclosure Components – OSFI B-15

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Governance

- Describe the board of directors' oversight of climate-related risks and opportunities.
- Describe management's role in assessing and managing climate-related risks and opportunities.

Strategy

- Describe the climate-related risks and opportunities the FRFI has identified over the short, medium, and long term.
- Describe the impact of climate-related risks and opportunities on the FRFI's businesses, strategy, and financial planning.
- Describe the resilience of the FRFI's strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario.

Risk Management

- Describe the FRFI's processes for identifying and assessing climate-related risks.
- Describe the FRFI's processes for managing climate-related risks.
- Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the FRFI's overall risk management.

Metrics and Targets

- Disclose the metrics used by the FRFI to assess climate-related risks and opportunities in line with its strategy and risk management process.
- Describe the targets used by the FRFI to manage climate-related risks and opportunities and the issuer's performance against these targets

Greenhouse Gas (GHG) Emissions

- Disclose the FRFI's Scope 1 GHG emissions and the related risks.
- Disclose the FRFI's Scope 2 GHG emissions and the related risks.
- Disclose the FRFI's Scope 3 GHG emissions and the related risks.
- Disclose the reporting standard used by the FRFI to calculate and disclose the GHG emissions referred to above.
- If the reporting standard referred to above is not the GHG Protocol, disclose how the reporting standard used by the FRFI is comparable with the GHG Protocol.

ISSB Cross-Industry Metrics

- Physical risks — the amount and percentage of assets or business activities vulnerable to physical risks.
- Transition risks — the amount and percentage of assets or business activities vulnerable to transition risks.
- Climate-related opportunities — the proportion of revenue, assets or other business activities aligned with climate-related opportunities, expressed as an amount or as a percentage.

KEY CONSIDERATIONS AHEAD

Maintain Financial Stability

Climate-related risks pose a significant threat to FRFI's business model and one of OSFI's role as a federal regulator is to ensure that financial institutions leverage appropriate risk management inputs to manage their operations effectively and prudently. While federal and global climate change-related policies and guidelines are important forward-looking initiatives that need to be integrated into the economy, the primary role of OSFI is to maintain the safety and soundness of the Canadian financial system. As such, a balanced approach will be required if Canada (and other jurisdictions) wants to meet climate-related targets while at the same time maintaining financial stability.

Business Strategy

Financial institutions must balance their traditional business model (which includes clients & companies in industries impacted by climate change) with the need to operate in an economy influenced by new climate-related rules and regulations. To be effective, FRFI's need to proactively manage this change to achieve both their business objectives, in addition to forward progress towards effective management of climate-related risks. "Building resilience against climate-related risks requires FRFIs to address vulnerabilities in their business model, their overall operations and ultimately on their balance sheet. This entails forward-looking approaches that are holistic, integrated and built on reliable empirical data and sound analyses".

Methodologies and Integration within Enterprise Risk Management

The inclusion of climate-related risks into a financial institution's enterprise risk management operations will be extensive and widespread. Almost all aspects will be impacted, from ad hoc analysis to formal processes such as stress testing, capital management, model management and operational risk management. In many instances, the individual impact will be isolated to the inclusion of new data elements or additional climate-related scenarios. Regardless, the implication is that each component of change will need to be carefully managed over an extended time period to ensure that the pieces integrate and meet the overall goals of the enterprise's climate risk management objectives.

Data Availability

To measure the effectiveness of new policies and procedures, information is a core element that requires reliable, timely and accurate data. As has been seen in other jurisdictions, the required data may not always be easily available, or in fact, may not even exist within a financial institution. While good data governance practices will be useful in the future, climate-related risk integration will need to evolve and continuously improve as model results and reporting output are measured and assessed over multiple time periods to separate the good data from the bad. In the interim, high quality proxy data may be leveraged, though it will need to be carefully scrutinized and continuously assessed to ensure it provides objective results.

Systematize Processes

Financial information traditionally flows effectively through an FRFI, from hundreds of source systems and centralized aggregation points to various internal and external reporting outputs. The introduction of climate-related risk data to policies, procedures and models poses a new challenge of not only identifying the required information but determining how to harvest it for repeated use. Ad hoc analysis is an effective approach for initial assessments but can prove to be a time consuming, trial & error activity as the enterprise information needs become larger and more complex. Putting in place the appropriate systems and procedures to source, aggregate and report data will allow for integration into risk models and systems, in addition to timely analysis and reporting.

CONCLUSIONS

Canadian financial institutions have been working for several years to integrate the concerns of climate-related risks into their business strategy, product offerings and operations. By taking a collaborative approach, FRFIs have voluntarily issued TCFD and ISSB financial disclosures in addition to working locally within their respective peer group, piloting early initiatives to identify and manage climate-related risks. By normalizing the inclusion of climate-related factors into business-as-usual risk management, banks and insurance companies will be in a better position to incorporate these changes into ongoing procedures, systems and reporting. As with any regulatory initiative, there is always an opportunity to improve data governance, optimize processes and build greater resilience into operations.

The latest step in the Canadian regulatory roadmap has been the release of draft guidelines that provides an initial, standardized approach that FRFIs can leverage with transparent objectives for governance, risk management and financial disclosure. To further the ongoing efforts, OSFI has provided a period of public consultation on the draft climate risk management guidelines. The final version will be issued in early 2023, including a summary of the public consultations and feedback received during the process. The Canadian regulator has also indicated that "given the pace of change in climate risk management, OSFI intends to review and amend this Guideline as practices evolve and standards harmonize". The ability to gather public feedback will help refine the approach, give transparency to the development process and create more stakeholder buy-in to the final guidelines, particularly if the output reflects the needs of industry, the Canadian public and the objectives of addressing climate-related risks in financial services.

Reference: Climate Risk Management (osfi-bsif.gc.ca)

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ABOUT CAPCO

Capco, a Wipro company, is a global technology and management consultancy specializing in driving digital transformation in the financial services industry. With a growing client portfolio comprising of over 100 global organizations, Capco operates at the intersection of business and technology by combining innovative thinking with unrivalled industry knowledge to deliver end-to-end data-driven solutions and fast-track digital initiatives for banking and payments, capital markets, wealth and asset management, insurance, and the energy sector. Capco's cutting-edge ingenuity is brought to life through its Innovation Labs and award-winning Be Yourself At Work culture and diverse talent.

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