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To: Office of the Superintendent of Financial Institutions

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Re: Request for Comment on OFSI's Draft Guideline B-15: Climate Risk Management, Submission by the Global Risk Institute in Financial Services

Contact: Sonia Baxendale, President and CEO (sbaxendale@globalriskinstitute.org)

August 17, 2022

Dear Superintendent,

Thank you for the opportunity to comment on Draft Guideline B-15: Climate Risk Management. B-15 is an essential step in ensuring all Federally Regulated Financial Institutions (FRFIs) develop greater resilience to climate-related financial risks, financial and operational risks posed by climate change are minimized, and climate impacts on the Canadian financial system are mitigated. The draft guideline is practical, proportionate, and complementary to other Office of the Superintendent of Financial Institutions (OSFI) guidance and emerging international standards. Guideline B-15 provides clear policy signalling to domestic and international financial institutions about the importance of climate risk management and regulator expectations while contributing to financial system stability.

The Global Risk Institute in Financial Services (GRI) is a member services organization founded by the public and private sectors in Canada. Our members include Canadian pension funds, banks, insurers, financial Crown corporations, and Provincial and Federal governing bodies. We are the premier thought leadership organization in risk management for the financial industry. Our organization brings together industry, academia, and government leaders to draw actionable insights on risk management, including climate risk. GRI has significant climate risk management and reporting expertise.

We are submitting our comments on Draft Guideline B-15: Climate Risk Management, drawing on our climate risk management, reporting expertise, and knowledge of best practices in Canada and globally.

Key themes GRI believes will be critical to the success of this guideline are transparency, comparability, iteration (continuous improvement), and timeliness. With these principles and themes in mind, we present the following commentary on the Draft Guideline B-15: Climate Risk Management.

## CHAPTER 1 - GOVERNANCE AND RISK MANAGEMENT EXPECTATIONS

<u>Governance - Principle 1:</u> The FRFI should incorporate the implications of climate change and the transition to a low greenhouse gas (GHG) economy to the FRFI in its business model and strategy.

Understanding "the impact of climate-related risks on…strategic, capital, and financial plans" is the basis for understanding the potential impact on long-term viability. This information feeds directly into FRFI's developing low-carbon transition plans, enabling FRFIs to manage climate-related risks better and monitor decarbonization pathways. Without this information, transition plans will not be actionable, potentially leading to greenwashing and unaccounted climate-related risk.

<u>Governance - Principle 2:</u> The FRFI should have the appropriate governance, policies, and practices in place to manage climate-related risks.

We are in agreement with OSFI that Boards of Directors should be responsible for overseeing their organization's climate-related financial risk management, setting an appropriate climate risk appetite, and monitoring associated progress/implementation. Clear accountability, commitment, and strategic integration from the board is required to govern climate risks and opportunities effectively. To achieve this, board members need to be climate competent by being well-equipped with the essential climate knowledge and skills to understand the scale and implications of climate-related risks. This will enable boards to approve and oversee appropriate frameworks, targets, and executive compensation incentives. In addition, FRFI boards should update committee charters to include a clear delineation of climate risk management roles and responsibilities.

GRI notes that the draft guidance states that the FRFI should take into account climate-related risks in Senior Management compensation, as appropriate. This is in line with the Bank for International Settlements (BIS) recent recommendation that "the board and senior management should consider whether the incorporation of material climate-related financial risks into the bank's overall business strategy and risk management frameworks may warrant changes to its compensation policies." In cases where a FRFI chooses to integrate climate-related targets in compensation plan methodologies or include climate metrics as performance targets, this should be disclosed.

<u>Risk Management: Risk Identification, Measurement, and Management & Risk Monitoring and Reporting - Principle 3:</u> 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.

GRI agrees entities "should have processes in place to adequately price climate risk-sensitive assets and liabilities and manage these exposures in accordance with" risk appetites. Climate-related risks are horizontal (cross-cutting traditional risk categories) impacting the entire organization, systemic in nature, increasingly complex, and continually increasing (in contrast to other financial risks that tend to be circular.) In addition, correctly pricing climate-related risks remains challenging for many entities as there are no generally accepted methods for evaluating climate risk on the loan level for banks, while for many insurance portfolios, there is insufficient information available.

To support timely and accurate practice among FRFIs, GRI recommends that OSFI provide further methodological direction on the "appropriate processes and controls to identify and measure the potential impact of climate-related risks on its portfolio of exposures (e.g., credit, market, operational, insurance, and liquidity)" or greater specificity to FRFI's regarding the parameters of these processes and controls. The provision of the guidance would result in FRFI outputs being more comparable and standardized.

Risk Management: Operational Preparedness and Resilience for Climate-Related Disasters & Awareness and Capabilities Building - Principle 4: The FRFI should mitigate the impact of climate-related disasters on its critical operations.

The field of operational resilience is maturing in FRFIs. Climate risk illustrates why it is important to view risks systemically using an integrated perspective, rather than by silos, or at an organization level alone. Potential disruptions from climate-related events are changing the way FRFIs need to plan for the impact of disasters on critical operations. For example, the area impacted by physical climate events such as floods and wildfires are more extensive than a disaster that may strike a specific building or street. Climate-related events are likely to strike an entire area or region, causing a systemic failure. This reinforces the need for thinking about operational resilience with a more strategic and systemic risk lens, including third party risk and those arising from wider value chains, with the onset of climate change.

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.

Climate risk scenario analysis is a vital tool in helping firms of all sizes understand what the future may hold in terms of physical and transition risk. It can inform materiality assessment, climate transition plans, and business strategy. Consequently, climate scenario analysis should be considered a critical component of OSFI's Climate Risk Management Guidelines and integrated into OSFI's Stress Testing Framework.

GRI recognizes climate scenario analysis is still in its early stages, is not yet standardized, and is hindered by the availability of credible data. Yet, we still view the practice as critical to effective long-term climate-related risk management and strategic planning. It is vital all firms start developing the ability to conduct scenario analysis, even if qualitative, to begin building internal capacity and awareness. Scenario analysis is quickly evolving in sophistication and granularity and becoming an expectation of investors to understand the potential financial impacts of significant climate-related risks.

We encourage OSFI to develop and release the stated "standardized climate scenario analysis exercise to assess aggregate exposures to physical and transition risks" as soon as possible, and work toward an industry-wide baseline standard that supports unique overlays depending on organizational size and scope of risk. These actions would simultaneously improve the comparability of outputs and ease implementation. GRI also encourages OSFI to provide standardized definitions of short, medium and long-term time horizons.

Capital Adequacy Requirement - Principle 6: The FRFI should maintain sufficient capital and liquidity buffers for its climate-related risks.

GRI is in agreement that, in principle, FRFIs "should incorporate climate-related risks into…Internal Capital Adequacy Assessment Process (ICAAP) or Own Risk and Solvency Assessment (ORSA) process."

Capital adequacy requirements depend on the effectiveness of climate risk management at institutions and how well climate-related risks are captured and valued. Currently, climate risk management, analysis, and valuation are in the nascent stages making climate data and risk models inadequate for incorporation into assessments of capital adequacy requirements. Yet, uncertain policy pathways and physical climate risk manifestation increase the likelihood that climate-related risks may not be adequately factored into capital requirements.

Guideline B-15 should be viewed as establishing the necessary foundations for climate risk management to inform future discussions about the level of capital buildup necessary to sustain financial system resilience into the 2030s and beyond.

Risk Management and Smaller FRFIs

In general, smaller FRFIs have a lower capacity and fewer resources yet arguably may face more significant risks due to characteristics such as potentially smaller capital buffers, lower levels of diversification, and less developed climate risk governance and management.

As Canada's economy includes high emissions and high climate risk sectors, it is essential for competitiveness and financial stability that smaller FRFIs develop strong climate-related risk management capabilities and transparent disclosures, including Scope 3 emissions. Institutions should not be exempt from assessing their Scope 3 emissions risk profile as these emissions constitute the most significant climate risk exposure for financial institutions and, in some cases, are undiversifiable. GRI recommends that FRFIs should determine the materiality of their Scope 3 emissions and proportionally integrate into risk management and reporting.

Smaller FRFIs could be provided with more flexibility and a longer timeline for Scope 3 reporting. In the interim, concrete steps should be outlined for smaller FRFIs to help build the foundations of climate risk governance, assessment, management, and reporting. This could include compliance checkpoints, continuing with OSFI-led pilots and workshops or developing partnerships with external organizations.

The provision of standardized scenarios, frameworks and data by OSFI will be crucial to increasing the capabilities of smaller FRFIs and should be published as soon as possible.

## CHAPTER 2 – CLIMATE-RELATED FINANCIAL DISCLOSURES

Good disclosure is a foundational building block of effective climate risk management. To position Canada and our financial sector competitively in the net zero global economy, we support OSFI's alignment with the IFRS's International Sustainability Standards Board (ISSB) which is providing the global baseline for global climate risk reporting. This will help enable the international harmonization of standards and reduce the reporting burden for firms operating in multiple jurisdictions.

Format of Disclosures

Unlike in Guideline B-15, the ISSB recommends that entities disclose climate-related information in the same location as the general-purpose financial reporting package. Incorporating climate disclosures into financial reporting increases the credibility of the disclosures, aligns disclosures with financial assumptions, and ensures climate disclosures to investors are made in a timely manner. GRI recommends the location and timing of FRFI climate-related disclosures be aligned with guidance from the ISSB.

Scope 3 Emissions Reporting

No institution should be exempt from assessing their Scope 3 emissions risk profile as these emissions constitute the most significant climate risk exposure and, in some cases, are undiversifiable. OSFI's guidance on Scope 3 emissions calculation and reporting is aligned with global standards such as the ISSB. Scope 3 calculation and reporting should be aligned, as proposed in Guideline B-15, with the Partnership for Carbon Accounting Financials (PCAF.)

Implementation Considerations

In general, GRI supports the implementation approach and timelines proposed by OSFI. We encourage large FRFIs or firms who have already disclosed in alignment with ISSB predecessors, the Task Force on Climate-Related Financial Disclosures (TCFD) and/or the Sustainability Accounting Standards Board (SASB), to implement OSFI's guidance in the immediate term. We advise that reporting requirements for climate-related financial risk be practical, differentiated by firm type/size, and proportional to risk exposure.

Supervision

GRI supports OSFI's approach of expanding its supervision and early intervention on climate risk through existing mechanisms. This would reduce the burden of oversight of Guideline B-15 and help mitigate the risk of introducing potential gaps or overlaps in OSFI's overall response to climate change. While climate change presents a unique set of challenges and opportunities to the Canadian financial system, we believe that the prevailing OSFI approach remains fundamentally fit for purpose. OSFI employees will resultingly have expanded duties, require specialized knowledge and must develop a sound understanding of how climate change ultimately transmits through the financial system and, by extension, the existing regulatory regime.

As mitigating climate-related risk and decarbonization pathways are not always linear, implementation expectations must be practicable. OSFI should continue to embrace the principles of flexibility, pragmatism, and iteration to ensure smooth implementation, and provide additional guidance and resources to help accelerate climate risk governance, assessment, management, and reporting.

## CONCLUSION

GRI supports OSFI's principles-based approach to climate risk management and disclosure expectations, and acknowledgement that Draft Guideline B-15: Climate Risk Management will be reviewed and amended as "practices evolve, and standards harmonize." This guidance is an important contribution to increasing long-term financial stability and addressing vulnerabilities within Canada's financial system.