Climate Change Risk

Key Current Themes

Risk Universe
by Risk Business

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Much has happened since our [February blog on environmental, social and governance (ESG) risks](). Both before and after the COP26 conference in Glasgow, the financial services sector and its regulators – around the globe – have been working hard to deliver on a range of environment-oriented commitments. As a result, a tsunami of material about climate change risk was published over just a few months, from about July through November 2021.

While it's impossible to capture everything published around the globe around the COP26 conference, below in the resources section we've tried to capture some of the more important materials that have been published, as an ongoing reference. This list, even though it is limited to certain key materials, is itself fairly extensive.

This report focuses on some key themes for operational risk and operational resilience professionals within the financial services sector that emerged from reviewing all these recently published materials. The five key themes are data, sustainable finance taxonomies, litigation, operational resilience and scenarios.

The progress firms have recently made around climate risk varies considerably, based on jurisdiction, business model, culture and a variety of other factors. Much of the focus to date has been on understanding the potential credit risk impact of climate risk. However, there is little doubt that there is also going to be wide ranging emerging non-financial risks too.

This brief overview of what is a complex topic is designed to stimulate further discussion and debate within firms – and their regulators – as to how the non-financial aspects of climate change risks should be addressed. It's clear from what's been published that the impact of those risks on some firms could, over time, be substantial. So, operational risk teams should be looking at these issues today, if they are not doing so already, to begin to better understand how climate risk might shape their risk appetite and alter their risk and control frameworks.

1 KEY THEME ONE: DATA

While a large volume of sustainable finance data has emerged over the past few years, there are considerable challenges around deploying it. Data is often not comparable across jurisdictions – and even within jurisdictions. For example, a Financial Stability Board paper on climate risk data notes that the official sector "is working to improve the availability and comparability of granular geophysical data sets across jurisdictions, as well as the ease and robustness with which they can be aggregated." This is despite the fact that such data sets have existed for a relatively long period of time. The paper also notes that achieving "additional and internationally comparable data on the drivers of transition risk – including on the scale and nature of jurisdictions' climate change targets and progress in meeting these – are also important."

The paper goes on to point out issues with other types of data, including corporate disclosures, financial institution disclosures, forward-looking financial stability metrics, risk transfer in the financial system metrics and data used within scenario analysis activities. Work on improving these data sets is at different stages. For example, the IFRS's efforts to develop a baseline global sustainability reporting standard – based on the TCFD framework – is only just now getting off the ground. For financial institutions, the FSB wants financial authorities to "consider how to improve the quality and consistency of data on financial institutions' exposures to climate-related risks, including those that arise from their exposures to non-financial counterparties (including their supply chains)."

Although climate change activists would like all of this to move much faster, for the financial sector and its regulators, work on these data challenges is actually moving at a fairly rapid clip. Consider, in comparison, how long it took to get Basel II over the line. However, this speed creates its own risks, including:

- **Regulatory risk**
  Given public pressure, the pace at which new regulations focusing on data and disclosure will be developed is likely to be fast. Firms need to be prepared to engage with regulators during consultations to ensure that any unintended consequences of rules can be mitigated.
- **Compliance risk**
  Consider, for a moment, the challenges that financial firms have consistently had with providing accurate MiFID II transaction reporting to regulators. There are real risks that firms without robust data governance in place around sustainable finance data will find themselves falling foul of the rules.
- **Reputational risk**
  Given the emotive nature of climate change generally, firms can expect much more public attention and a bigger impact on their business, as a result of breaches of any new regulatory obligations in this area. This could range from public boycotts to climate change protesters targeting physical locations.

In summary, although much progress has been made around sustainable finance data over the past few years, considerable work remains to be done, as it is challenging to compare data points on a like-for-

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like basis in most areas. Current work is focusing on implementing data governance programmes at national and international levels, as well as writing regulations around the use, supervision and disclosure of that data. Through all of this, financial services firms face the "risk of getting it wrong".

2 KEY THEME TWO: SUSTAINABLE FINANCE TAXONOMIES

If the data situation seems confusing, the taxonomy situation could be considered even worse. Many of the world's financial services hubs have developed their own sustainable finance taxonomies, in a race to become the default global sustainable finance taxonomy for the financial services industry. There is considerable irony here, because sustainable finance taxonomies are usually developed with the intention of clarifying some of the underlying data challenges, such as comparability.

So, what is a sustainable finance taxonomy? In its recent review of these taxonomies, the Bank for International Settlements (BIS) put forward the following definition: "A taxonomy for sustainable finance is a set of criteria that provide the basis for an evaluation of whether and to what extent a financial asset will support given sustainability goals. Its purpose is to provide a strong signal to investors, and other stakeholders, and assist their decision making – by identifying the type of information needed to assess the sustainability benefits of an asset and to classify an asset based on its support for given sustainability goals."

The BIS report examined three taxonomies: Sustainable Finance Taxonomy – Regulation (EU) 2020/852, China's Green Bond Endorsed Projects Catalogue (2021 Edition) and Climate Bonds Taxonomy (January 2021). Overall the report found "several weaknesses…including the lack of usage of relevant and measurable sustainability performance indicators, a lack of granularity and lack of verification of achieved sustainability benefits." This BIS paper then goes on to propose key principles for the design of effective taxonomies.

It seems likely that the taxonomy race is far from over – and given the issues identified by the BIS, that there will be at least a second generation of sustainable finance taxonomies developed to overcome some of the failings of the first round. While firms will have to adopt certain taxonomies to be able to operate in particular jurisdictions, they would be wise to avoid "baking in" a particular taxonomy into their processes, which could result in a lack of flexibility in the face of regulatory change in this fast-moving area. A less risky

approach would be to adopt a taxonomy-neutral approach to data management for compliance and risk processes, as well as for the firm's overall operations. Over the next few years, there is likely to be significant evolution within the sustainable taxonomy space, so firms need to be agile enough to manage the risks associated with this trend now.

3 KEY THEME THREE: LITIGATION

Climate-related litigation is defined by the United Nations Environment Programme as "cases that raise material issues of law or fact relating to climate change mitigation, adaptation, or the science of climate change." According to a recent LSE report, there are a growing number of cases that are focusing on "financial risks, fiduciary duties, and corporate due diligence, which directly affect not only fossil fuel and cement companies, but also banks, pension funds, asset managers, insurers and major retailers, among others." Examples of the types of cases include greenwashing, failure to disclose and manage climate change risk, cases seeking the recognition of corporate human rights responsibilities and cases that challenge specific projects or developments. Another analysis of the growing amount of climate-related litigation, by the Central Banks' and Supervisors' Network for Greening the Financial System, discusses "cases alleging breaches of fiduciary duties, for instance if a bank's directors continue to decide to finance highly greenhouse gas emitting projects. It is also conceivable that financiers may be sued as 'indirect polluters' for financing such polluting projects."

As discussed above, the rapidly evolving nature of sustainable financing data and disclosure practices create enormous risks for financial firms, but so do their core business activities. From the way they market financial activities to the corporate finance activities that they choose to engage in, banks are very vulnerable. Asset managers are also at risk, from misselling accusations to reputational damage from investing client money in certain companies or industries. In many cases, the seeds of future loss events are being sown today. This presents an enormous challenge for risk managers across both financial and non-financial risks. Firms may wish to actively include climate-related topics in risk control self assessments (RCSAs) if they are not doing so already and have open and frank conversations with business leaders to try and ascertain where climate-related emerging risks may be festering in the business. Mitigation steps taken today could save the organisation considerable time and attention by preventing a legal risk event in the future.

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4 KEY THEME FOUR: OPERATIONAL RESILIENCE

With many regulators around the globe focusing on operational resilience issues over the past few years – even pre-pandemic – it's not surprising to see the topic being mentioned, albeit not named explicitly, in the Basel Committee on Banking Supervision's recent consultation paper, Principles for the effective management and supervision of climate-related financial risks. According to the paper, "banks should assess the impact

> **Third party relationships that many firms have can widen geographical exposure to weather events**

of climate-related risk drivers on their operations in general and their ability to continue providing critical operations. Banks are expected to analyse how physical risk drivers can impact their business continuity and to take material climate-related risks into account when developing business continuity plans."

Freak weather events over the past few years – from widespread wildfires in California and Australia to a winter storm knocking out electricity for thousands of customers in the north of England for more than a week – create challenging business continuity circumstances for firms. In addition, the third party relationships that many firms have around the globe can widen geographical exposure to weather events considerably. For example, call centres in developing nations can have less physically robust structures, or infrastructure. And no matter where a third party is based, if it suffers physical damage as a result of a weather event, issues can arise such as the vulnerability of the data the third party has to being obtained by unauthorised actors.

However, freak weather isn't the only operational resilience issue firms should be considering. Another important issue is potential protest activity in the name of climate change. This could range from individuals blocking access to branches or demonstrating aggressively outside a headquarters building, all the way to potential terrorist or cyber activity by political actors who may use climate change as a cover but have other agendas to deliver on. Financial firms need to prepare for this as well –for employees to be able to work remotely, to deliver services to customers who cannot access them because of disruption, etc.

So, as firms implement their operational resilience programmes, it makes sense to bake in climate change from the beginning. Firms should consider the operational resilience of their business processes – including their risk and compliance processes – in light of a variety of potential climate change-related disruptions. For some particularly high-profile firms, it can also make sense to monitor traditional and social media for potential emerging operational resilience issues.

5 KEY THEME FIVE: SCENARIOS

One area where regulators have been working for some time and have made considerable progress, is scenario assessment of the risks associated with climate change. The Central Banks' and Supervisors' Network for Greening the Financial System published a report in October, [Scenarios in Action: A progress report on global supervisory and central] [bank climate scenario exercises](), which outlines the current state of play. For the report, 31 NGFS members around the globe shared information through a survey of their completed, in progress, or planned climate scenario assessments. The participants made use of the global set of scenarios and guidance on conducting the exercises that the Network had published previously. Many participants were conducting climate scenarios for the first time and the exercise was fruitful, acknowledging successes and also identifying challenges, such as data quality.

However, most of the scenarios focused on climate risks to credit portfolios – at the time of the report, only one member had included climate litigation in their exercise. Clearly there is a lot more work to be done by both financial regulators and firms themselves around scenario analysis for climate risk-related non-financial risks, and operational resilience.

Given the scale of the non-financial risks that financial services firms are potentially facing, it makes sense to start incorporating climate change risks within the emerging risk work that they undertake. Some firms are already doing that, at least in part, today.

One of the challenges of doing credit scenarios around climate risk is the lack of historical data to use as a base. While this is also true for operational risk and operational resilience scenarios, firms do have data they can leverage. For example, operational risk databases already hold information about past misselling loss events, extreme weather-related incidents and reputation-damaging litigation. While this data isn't the same as actual climate risk operational risk data, it can be used to benchmark and sense check operational risk and resilience scenarios.

Overall, firms can learn quite a lot from the work that the financial regulators are doing and the challenges they are facing. Firms can leverage those insights to build their own climate risk scenarios for both financial and non-financial risk. These scenarios, even if they are preliminary in nature with caveats, can help shape meaningful board and senior management discussions about climate risk within the risk appetite and related changes to the firm's risk and control framework.

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CONCLUSION

Understanding of climate risk – and its impact on financial services firms and the financial system as a whole – is still in its very early days. While much of the focus at the moment is on getting to grips with the credit risk impacts, there is little doubt that firms face significant operational risk and operational resilience challenges around climate change too.

Some firms are starting to get to grips with these issues, but more needs to be done. There is little doubt that COP26 accelerated many projects, both for firms and for regulators. However, financial firms cannot rest on their laurels – there are too many challenges ahead – they must press on in their development of a deeper and more nuanced understanding of this significant risk.

FURTHER READING

Bank for International Settlements (BIS)

Podcast – Beyond green swans: the BIS's work on climate
https://www.bis.org/press/podcast.htm

A taxonomy of sustainable finance taxonomies
https://www.bis.org/publ/bppdf/bispap118.htm

Pablo Hernández de Cos, Governor of the Bank of Spain and Chair of the Basel Committee on Banking Supervision: Climate risk, energy transition, financial risks and global economic growth
https://www.bis.org/review/r211202e.pdf

Ignazio Visco, Governor of the Bank of Italy: Awards ceremony for the G20 TechSprint on green and sustainable finance
https://www.bis.org/review/r211201b.pdf

Frank Elderson, Member of the Executive Board of the ECB: When You Need Change to Preserve Continuity – Climate Change and the Role of Law
https://www.bis.org/review/r211130e.pdf

Basel Committee on Banking Supervision

Principles for the effective management and supervision of climate-related financial risks
https://www.bis.org/bcbs/publ/d530.htm

Climate-related financial risks - measurement methodologies
https://www.bis.org/bcbs/publ/d518.htm

Climate-related risk drivers and their transmission channels
https://www.bis.org/bcbs/publ/d517.htm

Financial Stability Board

FSB roadmap for addressing climate-related financial risks
https://www.fsb.org/2021/07/fsb-roadmap-for-addressing-climate-related-financial-risks/

2021 Status Report: Task Force on Climate-related Financial Disclosures
https://www.fsb.org/2021/10/2021-status-report-task-force-on-climate-related-financial-disclosures/

Implementing the Recommendations of the Task Force on Climate-related Financial Disclosures
https://www.fsb.org/wp-content/uploads/P141021-4.pdf

Task Force on Climate-related Financial Disclosures: Guidance on Metrics, Targets, and Transition Plans
https://www.fsb.org/wp-content/uploads/P141021-2.pdf

FSB roadmap for addressing climate-related financial risks
https://www.fsb.org/2021/07/fsb-roadmap-for-addressing-climate-related-financial-risks/

The availability of data with which to monitor and assess climate-related risks to financial stability
https://www.fsb.org/2021/07/the-availability-of-data-with-which-to-monitor-and-assess-climate-related-risks-to-financial-stability/

Report on promoting climate-related disclosures
https://www.fsb.org/2021/07/report-on-promoting-climate-related-disclosures/

Task Force on Climate-related Financial Disclosures

Publications page
https://www.fsb-tcfd.org/publications/

International Sustainability Standards Board
https://www.ifrs.org

IFRS Foundation announces International Sustainability Standards Board, consolidation with CDSB and VRF, and publication of prototype disclosure requirements
https://www.ifrs.org/news-and-events/news/2021/11/ifrs-foundation-announces-issb-consolidation-with-cdsb-vrf-publication-of-prototypes/

International – Other documents

Sustainable Taxonomy development worldwide: a standard-setting race between competing jurisdictions
https://gsh.cib.natixis.com/our-center-of-expertise/articles/sustainable-taxonomy-development-worldwide-a-standard-setting-race-between-competing-jurisdictions

Global trends in climate change litigation: 2021 snapshot
https://www.lse.ac.uk/granthaminstitute/wp-content/uploads/2021/07/Global-trends-in-climate-change-litigation_2021-snapshot.pdf

US Federal Reserve

Climate Change and Financial Stability
https://www.federalreserve.gov/econres/notes/feds-notes/climate-change-and-financial-stability-20210319.htm

Growth at Risk From Climate Change
https://www.federalreserve.gov/econres/feds/files/2021054pap.pdf

The Macro Effects of Climate Policy Uncertainty
https://www.federalreserve.gov/econres/feds/files/2021018pap.pdf

Lael Brainard, Member, Board of Governors of the Federal Reserve System: Building Climate Scenario Analysis on the Foundations of Economic Research
https://www.federalreserve.gov/newsevents/speech/files/brainard20211007a.pdf

Randal K. Quarles, Chair Financial Stability Board and Vice Chair for Supervision, Board of Governors of the Federal Reserve System: Disclosures and Data: Building Strong Foundations for Addressing Climate-Related Financial Risks
https://www.federalreserve.gov/newsevents/speech/files/quarles20210711a.pdf

Federal Reserve Bank of San Francisco: Why Climate Change Matters to US
https://www.frbsf.org/our-district/about/climate-risk/

US Office of the Comptroller of the Currency

Acting Comptroller of the Currency Michael J. Hsu: Five Climate Questions Every Bank Board Should Ask
https://www.occ.gov/news-issuances/speeches/2021/pub-speech-2021-116.pdf

OCC Announces Climate Change Risk Officer, Membership in the NGFS
https://www.occ.gov/news-issuances/news-releases/2021/nr-occ-2021-78.html

Central Banks and Supervisors Network for Greening the Financial System (NGFS)

Climate-related litigation: raising awareness about a growing source of risk
https://www.ngfs.net/sites/default/files/medias/documents/climate_related_litigation.pdf

Progress report on the Guide for Supervisors
https://www.ngfs.net/sites/default/files/media/2021/11/08/progress_report_on_the_guide_for_supervisors.pdf

Scenarios in Action: a progress report on global supervisory and central bank climate scenario exercises
https://www.ngfs.net/sites/default/files/medias/documents/scenarios-in-action-a-progress-report-on-global-supervisory-and-central-bank-climate-scenario-exercises.pdf

UK Financial Conduct Authority

Hub page on website for climate change
https://www.fca.org.uk/firms/climate-change-sustainable-finance

Climate Financial Risk Forum
https://www.fca.org.uk/transparency/climate-financial-risk-forum

Hub page on climate-related reporting requirements
https://www.fca.org.uk/firms/climate-change-sustainable-finance/reporting-requirements

FCA Climate Change Adaptation Report
https://www.fca.org.uk/publications/corporate-documents/fca-climate-change-adaptation-report

FCA consults on further climate-related disclosure rules
https://www.fca.org.uk/news/press-releases/fca-consults-further-climate-related-disclosure-rules

European Union

EU Sustainable Finance Hub Page
https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en

EU further delays sustainable finance rules for asset managers
https://www.reuters.com/business/sustainable-business/eu-further-delays-sustainable-finance-rules-asset-managers-2021-07-09/

International Platform on Sustainable Finance
https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/international-platform-sustainable-finance_en

Information on participation in the 2022 ECB Climate Risk Stress Test
https://www.bankingsupervision.europa.eu/press/letterstobanks/shared/pdf/2021/ssm.2021_letter_on_participation_in_the_2022_ECB_climate_risk_stress_test~48b409406e.en.pdf

EU taxonomy for sustainable activities
https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en#why

Corporate Sustainability Reporting Directive (CSRD)
https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0189

Sustainable corporate governance
https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12548-Sustainable-corporate-governance_en

About Risk Universe

Risk Universe by RiskBusiness provides in-depth analysis, reviews and research on areas of interest within the broader governance, risk, audit and compliance landscape, designed to provide proactive, 360° intelligence for informed decision making across the enterprise.

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