Financial Risks from Climate Change

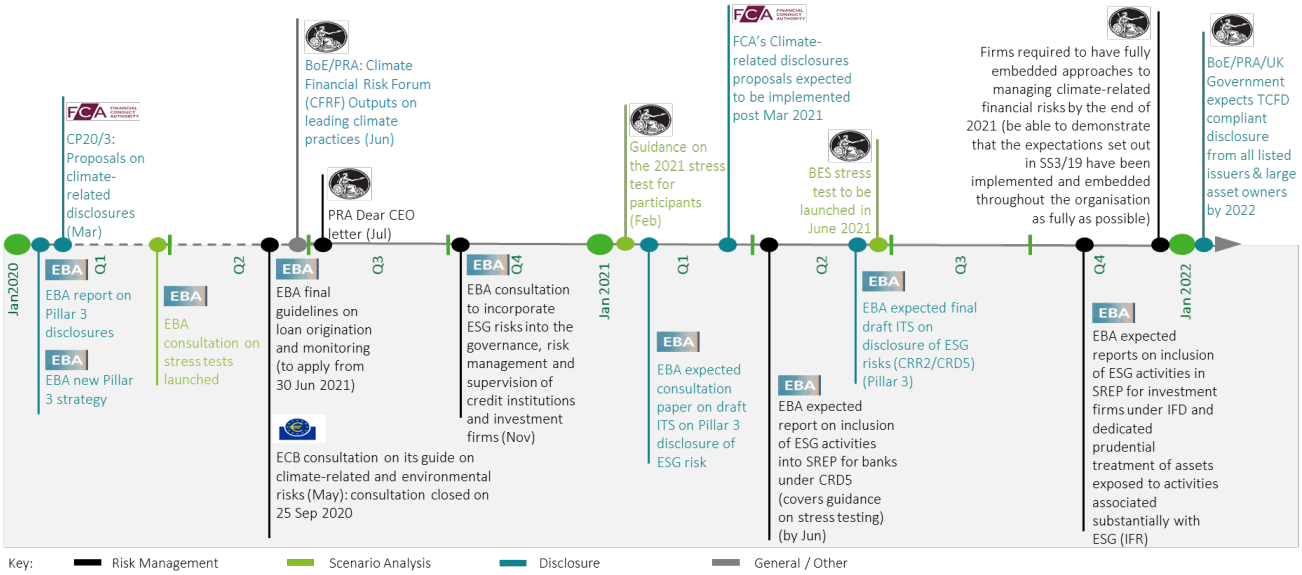
Key developments and takeaways from 2020

February 2021

2021 offers an important challenge to the Financial Services Industry – being able to quantify climate impact. The increased expectations from regulatory authorities has made it a key priority for most financial institutions in 2021 and successfully meeting those expectations calls for a cross-functional team effort. This summary explores some of these expectations, provide insight into Nordic themes and give considerations for how firms can prepare.

Financial services regulators are increasingly expecting industry participants to recognise the importance of climate-related risks and to respond with a coherent climate risk plan to manage the financial risks from climate change (FRfCC). This trend has become global, with supervisory authorities from Hong Kong to Canada accelerating the adoption of climate risk management practices, in varying degrees and some making adoption mandatory. Two jurisdictions – the European Union and the United Kingdom (UK) - serve as notable examples (see timeline below) with numerous papers and consultations published on this topic during 2020. These examples make it clear that there is an increased expectation on banks to adequately address the FRfCC and reassess their strategic resilience to climate change policy. This trend is expected to continue in 2021 with key guidance expected from the European Banking Authority (EBA) on e.g., disclosure of Pillar 3 ESG risks and reports on ESG integration into risk management. Similarly, the UK Prudential Regulatory Authority (PRA) will launch the Bank of England (BOA) 2021 stress test, including climate risk, and banks will be required to have fully embedded approaches to managing climate-related financial risks by the end of 2021.

Financial Services Industry participants are increasingly expected to recognise the importance of climate-related risks and to respond with a coherent climate risk plan

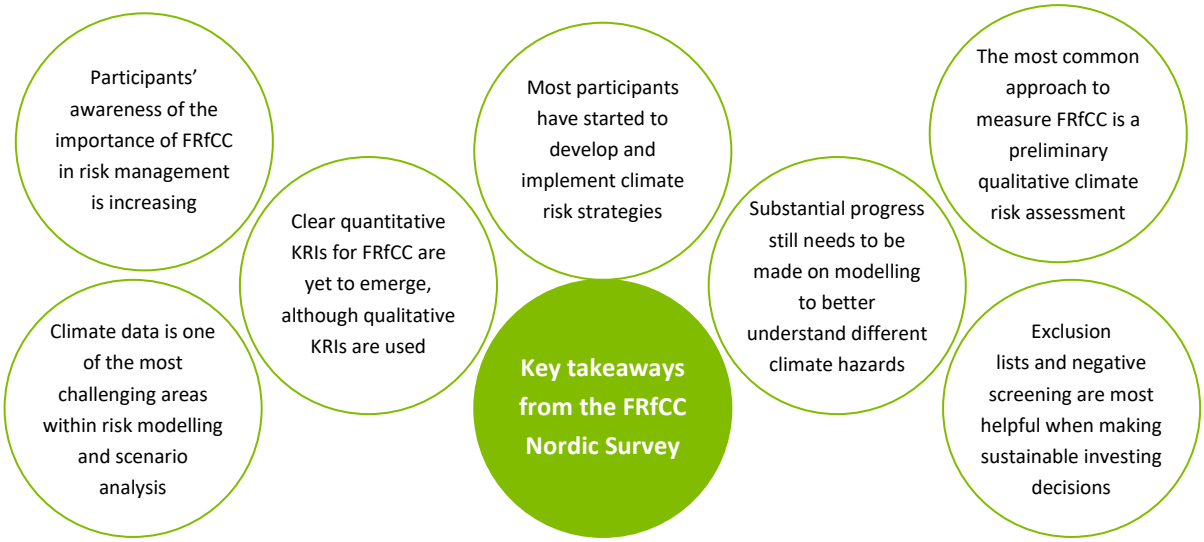


Supervisory focus on climate risk measurement and reporting in the Nordics during 2021

The Nordic regulatory authorities have been largely following European developments rather than issuing their own direct guidance on the topic of assessing and managing FRfCC for the banking sector. Climate-related risks and its regulation are, and will continue to be, a key area of supervisory focus[1] for the foreseeable future. The Danish FSA, the Norwegian FSA and the Swedish FSA announced that they in 2021 will look at how financial firms measure and report climate-related risks[2].

Deloitte conducted a Nordic survey covering a range of FRfCC topics

In order to facilitate a better understanding of how financial institutions are preparing to measure, manage and report the effects of FRfCC across the Nordics, Deloitte conducted a survey toward the end of 2020 covering a range of FRfCC topics. The survey[3] addressed physical risks (risks associated with the physical effects of climate change e.g. extreme weather conditions), transition risks (risks associated with the transition to a low-carbon economy e.g. changing climate policies with significant potential negative impacts on assets, earnings and reputation) and liability risks (risks associated with class action suits for inadequate, or inaccurate disclosure of climate risks e.g. pollution). The survey was grouped into five sections with approximately 30 questions covering five themes, namely General, Governance, Risk modelling, Climate scenarios & stress testing and Sustainable investing.



Specific challenges set climate risk apart from traditional risk types

Financial institutions should be able to leverage, to some extent, existing governance and risk management architecture to address new regulatory expectations. However, there are several challenges which set climate risk apart and mean that one cannot just "copy and paste" what is done for other risk types[4].

Data	Predicting future risks	Due diligence
There is a scarcity of relevant, granular, and forward-looking data. Even though there is an abundance of climate ratings, divergent methodologies across vendors mean that the ratings assigned to each counterparty can vary significantly.	Climate risks are highly uncertain and non-linear in their propagation, and can affect multiple risk categories simultaneously. Historical loss experience cannot be used to estimate the risks.	Due diligence in relation to climate risk is required on all (material) counterparties banks are transacting with across the value chain. This may need to cover their clients' overall strategic resilience to climate risks and critically their supply chains.
Expertise	**Time horizon**	**Proportionality**
There is a lack of expertise on, and understanding of, climate risk across the banking industry at all levels of seniority, as the mix of skills, knowledge and experience required is new and complex.	Climate risks are expected to materialise over a long time horizon. This requires an extension of traditional bank strategic planning horizons, which are typically three to five years.	There is uncertainty about the appropriate governance structures required for different sized firms, and the level of detail needed to meet disclosure standards effectively.

[1] https://www2.deloitte.com/dk/da/pages/risk/articles/reviewing-the-regulatory-outlook-2020.html
[2] https://www.fi.se/en/published/press-releases/2021/fis-prioritised-areas-for-2021/
[3] Deloitte - Financial Risks from Climate Change Nordic Survey, 2020. The complete survey results are available to survey participants.
[4] Climate change poses new, significant and complex challenges for banks https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/financial-services/deloitte-uk-fs-climate-change-and-banks.pdf

Linking business strategy to risk appetite and risk management

For a long time, sustainability has been an important part of business strategy, purpose communication and brand positioning, especially in the Nordics. Now, the new and increasing regulatory expectations are turning sustainability to a key focus for Risk leaders, triggering new definitions of climate risk appetite as well as implementation in risk management. Well implemented, risk appetite limits will bring effective control over business as usual adherence to climate ambitions and business strategy execution, provided the two are closely aligned and mutually supportive. However, if risk appetite is not aligned to business/climate strategy, this will cause major disruption and disturbance, making both very complicated to pursue. When setting climate change strategy, the Board will need to determine how prominent a role it wants to play on the climate change agenda. This will need to reflect the institution's business ambitions as well as its response to regulatory expectations and investor activism. It will also need to reflect its engagement with customers and climate change aspirations of clients. Strong ongoing alignment between the institution's business strategy and its Risk

Five building blocks for framing Climate Risk Appetite

The different roles an institution may choose to adopt in relation to the climate change agenda, each with a different emphasis and implication for risk appetite[1]

Appetite Statement (RAS) has always been an important success factor in making the business strategy operationally sound. This holds true for climate risk[1]. The exceptionally forward-looking and cross-cutting nature of climate risk does, however, require a more iterative process to ensure strong ongoing alignment between climate change strategy and the RAS.

Striking speed of insight and learning amongst the Nordic Financial Institutions

The Nordic financial services industry is undergoing an intense phase of comprehension, internalisation and development in getting ready to measure, manage and report the effects of FRfCC. The responses from Deloitte's Nordic FRfCC survey clearly testified to Nordic financial institutions working to better understand both climate change and ESG Risk (Environmental, Social, Governance), as well as how it would impact their business. Many of the financial institutions that participated have already moved a long way since the survey was conducte, with a striking speed of new insight, maturity and learning, as financial institutions have analysed and internalised the new expectations, identified areas of particular challenge and zoomed in on specific needs for new and innovative approaches or solutions.

[1] Building Blocks for Framing your Climate Risk Appetite - Series Introduction, Rutang Thanawalla, Jan-Hinnerk Fahrenkamp, Jack Webb (deloitte.com)

Last year, after a period of public discussions and debates on the importance of sustainability, boards and senior executives of financial institutions effectively started demanding much clearer definition and quantification of climate risk. Regulators expect Boards to pose robust challenge and provide effective oversight of their bank's identification and management of climate risk. Although the broad topics are familiar, the specific issues pertinent to climate change are new, significant and complex. The most proactive financial institutions have already developed climate risk strategies, establishing senior committees to support broader sustainability efforts and associated risk management[1].

BoD attention to climate and sustainability has increased significantly over the past 12 months

Sustainability Officers emerging as "Sense-makers in Chief", playing a key role in establishing sound sustainability governance

The role and mandate of the Chief Sustainability Officer (CSO) is now clearer than ever and is expected to continue to gain prominence over the coming years. The CSO is emerging as the organisation's "sense-maker in chief." Understanding and predicting changes in the external sustainability environment has become essential to the role. So has navigating, influencing, and cutting through organisational complexities to allow the organisation to deliver on its ESG commitments for commercial gain[2].

Sustainability interactions of a CSO in a typical financial institution

Amongst Nordic financial institutions, clarification of roles and governance structures to appropriately manage FRfCC is increasing. Some have already proceeded to assigning greater and more specific responsibilities to individuals and teams across different areas of the business and to closer tie together risk management to Sustainability strategy[3]. The CSO plays a fundamental role in the governance of sustainability through establishing sound governance structures that ensure proper consideration of risks. CSOs also support many governance bodies, such as advising the board, chairing ESG sub-committees, participating in taskforces and helping to shape the agenda on risk, audit, compensation and major change committees[2].

Strengthening of governance, roles and structures to address and facilitate climate risk management as well as the broader ESG agenda

[1] Climate change and banks - Questions Boards should be asking, December 2020 https://www2.deloitte.com/uk/en/pages/financial-services/articles/climate-change-and-banks.html
[2] The future of the Chief Sustainability Officer https://www2.deloitte.com/global/en/pages/financial-services/articles/the-future-of-the-chief-sustainability-officer.html
[3] Deloitte - Financial Risks from Climate Change Nordic Survey, 2020. The complete survey results are available to survey participants.

Many banks still find it challenging to measure and quantify climate risk and its impact across their entire range of services and products. Many organisations have started to articulate their climate risk appetite and defined some risk measurements and most have also been able to do risk vulnerability assessments. The establishment of clear quantitative Key Risk Indicators (KRIs) in firms' RAS is the appropriate next step.

Quantification of climate risk across risk types is the appropriate next step

Climate data quality and accessibility is widely quoted as one of the most challenging areas within risk modelling and scenario analysis. The effort required to access more and new information from clients to supplement existing data can be an enormous task, although it is crucial for firms to understand its most material counterparties' climate and sustainability credentials. Five reasons why firms should attempt to profile counterparties for climate and ESG risks, and hence increase the information and data availability on these clients are:

1. Climate stress testing has become an expectation for banks in several regulatory jurisdictions
2. Reputational risk and the business imperative
3. Growing expectation on high-quality climate disclosures
4. Sustainable credit decisioning
5. Commitment to the climate transition & impact agenda

Access to data is one of the key challenges, but it is important to start somewhere

Varying 2021 regulatory stress test plans may result in a fast and a slow lane

2021 will indeed be a busy year of intense work towards articulating climate ambitions, setting standards, understanding and resolving data challenges and working towards transparency. Some European countries have planned climate stress tests (with a wider stress test planned by the EBA for 2022), which might effectively place financial institutions in a fast lane, or a slow lane. For countries where stress tests are not planned, it will therefore be key for financial institutions to show progress on key issues to not lag behind. This year, time is likely to truly fly.

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