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Creating a climate of change digest

Climate risk regulatory developments in the financial services industry

Leading off

On July 18, 2024, the Financial Stability Board (FSB) published a stocktake of member financial authorities' initiatives related to the identification and assessment of nature-related financial risks. In addition to supervisory and regulatory initiatives, the stocktake discusses the perceptions of central banks and supervisors on whether nature degradation is a financial risk.[1]

The stocktake report,[2] prepared for the G20 Finance Ministers and Central Bank Governors meeting held July 25–26, 2024, reveals that financial authorities across the world are at different points in recognizing nature-related risks to their stability. It added that while some regulators have recognized biodiversity loss, and other nature-related factors present "material financial risks," others were only starting to track this subject due, in part, to a lack of data, as well as it not yet being presented by some participants on the same scale of urgency with climate risk.

The lack of reliable data and accurate models to link underlying nature-related risks with financial exposures is one of the major challenges highlighted in the report. This lack of information prevents financial authorities and institutions from aggregating these exposures into well-defined, internationally comparable measures of financial risk.

As per the report, regulatory and supervisory work remain embryonic on a global level with significantly differing approaches between jurisdictions. Some financial authorities (especially in

advanced economies and a few emerging markets) have already taken regulatory and supervisory actions to deal with nature-related risks, but specific strategies might vary. One often seen approach is the promotion of firm-level disclosures regarding nature-related risk. The development comes as part of regulators' drive for greater transparency in a bid to help financial institutions better measure and control these risks.

Further, the report highlights linkages between climate-related and nature-related financial risks. Policymakers acknowledge the close relationship between climate change and nature degradation, meaning financial risk management should take into higher consideration alignment across these two domains in a more integrated way. Advancing such an integrated view would make for a more complete evaluation of financial risks, covering all relevant bases.

A further important observation in the FSB report is that there is limited expertise among financial regulators, central banks, and private-sector firms when it comes to identifying or managing nature-related financial risks. Initiatives are underway globally to build capacity in understanding this gap.

On July 18, 2024, the United Nations Environmental Programme Finance Initiative (UNEP FI) released the first set of reports providing guidance for banks helping them implement and benefit from the interlinkages between the circular economy and major sustainability challenges of climate change, nature loss, and pollution.[3]

The two published reports are part of a new series of resources titled "Circular Economy as an Enabler for Responsible Banking." This resource series aims to help the 300+ signatories of the Principles for Responsible Banking, as well as the wider banking sector, to move from target-setting for sustainability objectives to delivering on climate commitments.[4] In addition to the reports, UNEP FI has also published two supplements to guide banks to develop sector-specific financing strategies that promote circular economy principles in the buildings/construction and textile sectors, which are two high-impact sectors with high circularity potential.[5]

The published resources are summarized below:

1. **Circular Economy as an Enabler for Responsible Banking: Leveraging the Nexus between Circularity and Sustainability Impact:[6]** This is the opening report in the "Circular Economy as an Enabler for Responsible Banking" series of resources and aims to identify and operationalize the nexus between circular economy and climate, nature, pollution, and healthy and inclusive economies.
2. **Circular Economy as an Enabler for Responsible Banking: Circular Solutions to Achieve Climate Targets:[7]** While the opening report gives an overview of the interlinkages between the circular economy and other sustainability objectives, this report specifically focuses on how banks can operationalize the nexus between the circular economy and climate mitigation. This climate-focused report is supported by the two sector supplements.
   - Supplement 1: Circular Solutions to Achieve Climate Targets in the Buildings and Construction Sector[8]
   - Supplement 2: Circular Solutions to Achieve Climate Targets in the Textile Sector[9]

UNEP FI plans to continue the resource series with publication of additional sectoral supplements focusing on the nexus with climate, and starting in 2025, UNEP FI intends to co-develop new guidance with banks to show how the transition to a circular economy can benefit nature, mitigate pollution, and aid in developing healthier and more inclusive economies.

On July 24, 2024, the Science Based Targets initiative (SBTi) released a draft of its Financial Institutions Net-Zero (FINZ) Standard for a second round of multistakeholder public consultation.[10]

SBTi had previously conducted a public consultation on an initial draft version of the FINZ Standard in 2023[11] and updated the draft standard upon review of feedback it received. In this second round of consultation, SBTi has invited the review and input of experts in the finance sector, academia, and civil society on the draft FINZ Standard.[12] Based on feedback received, which was open until September 20, 2024, through this second public consultation survey, SBTi will shape the final standard. To help make this engagement easier, SBTi held a global webcast on August 22, in which it gave a walkthrough of the draft FINZ Standard and answered stakeholder questions about it. SBTi had also separately called for financial institutions to pilot test the draft standard and submit feedback.[13] The pilot test will run parallel to the public consultation and will be used to inform the final version of the FINZ Standard.

The draft FINZ Standard is built around five outcomes for financial institutions (FIs) with five corresponding sections that are under consultation:[14]

Outcome	Draft FINZ standard section
Robust climate governance	Entity level: Organizational commitments and leadership
Comprehensive assessment of climate impacts	Greenhouse Gas (GHG) accounting: Exposure and portfolio emissions
Climate alignment of relevant financial activities	Portfolio climate-alignment targets
Climate emission-intensive activities	Emission-intensive sector targets
Transparency and reporting	Reporting

Refining the Financial Institutions' Near-Term (FINT) Criteria document,[15] the draft FINZ standard advances beyond its predecessor, used by more than 120 financial institutions to set validated science-based targets. It sets out to build on the framework so that financial institutions can establish near-term as well as long-term net-zero commitments, and it broadens in scope with respect to some additional financial services (insurance underwriting and capital market activities).

After the public consultation and pilot testing phases, the SBTi will review the feedback and make necessary changes to the draft.

The revised draft will then be submitted to the Technical Council for review and approval. Once approved by the Technical Council, the draft will be presented to the Board of Trustees for final consideration. If adopted, the FINZ standard will replace the current FINT Criteria, providing a framework for financial institutions to set and achieve net-zero targets.

On July 30, 2024, the SBTi published four technical outputs as a preliminary step in its process for the revision of the SBTi Corporate Net-Zero Standard.[16]

According to the previously announced timeline[17] and Standard Operating Procedure[18] for the review of the Corporate Net-Zero Standard, the revision project of the SBTi Corporate Net-Zero Standard involves a research phase where the Technical Department will review published SBTi standards that may overlap with the standard under development to ensure alignment and consistency. The four technical publications that are released are the research-focused technical outputs that will inform the development of the revised Corporate Net-Zero Standard.

The four technical outputs are summarized below:

1. **Scope 3 Discussion Paper:[19]** This paper provides an overview of the status and current practices of scope 3 target setting among companies with SBTi-validated targets.
2. **Evidence on the effectiveness of Environmental Attribute Certificates:[20]** This is a compilation of 438 pieces of eligible evidence that was received in response to the SBTi's open call for evidence on the effectiveness of the use of environmental attribute certificates (EACs) in corporate climate targets in 2023.[21]
3. **Synthesis report of evidence on the effectiveness of Environmental Attribute Certificates in corporate climate targets:[22]** This is the first of three distinct reports that will summarize evidence collected on carbon credits' effectiveness in corporate climate targets. This research will inform potential changes in the eligible use of different types of EACs in SBTi standards.
4. **Findings of independent systematic review on the effectiveness of carbon credits in corporate climate targets:[23]** This will provide a brief on the systematic review commissioned by SBTi to assess evidence from peer-reviewed scientific literature on the effectiveness of corporate use of carbon credits as an alternative to direct emission abatement as part of company decarbonization efforts.

Some key findings from the research:

1. Five illustrative scenarios are outlined in the Scope 3 Discussion Paper[24] to explore how certification and environmental attribute certificates might help to substantiate claims in corporate mitigation strategies consistent with achieving net-zero emissions globally.
   i. The priority of all the outlined scenarios is direct decarbonization of the value chain.
   ii. Three scenarios are related to carbon credits and do not include offsetting emissions.
2. More research is needed on the effectiveness of the use of carbon credits (emissions avoidance and reduction) by companies under different use cases, as noted in the Synthesis report.
3. The evidence received in response to SBTi's open call for evidence is discussed under three main themes:
   i. Mitigation outcomes and conditions for effectiveness: Empirical and observational evidence suggests that various types of carbon credits are ineffective in delivering their intended mitigation outcomes.
   ii. Corporate use cases for carbon credits and implications for net-zero aligned transformation and climate finance: Evidence suggests that there could be clear risks to corporate use of carbon credits for the purpose of offsetting, including potential unintended effects of hindering the net-zero transformation and/or reducing climate finance.
   iii. Claims: The evidence challenges the legitimacy of offsetting claims, arguing that treating carbon credits as fungible with other sources, sinks, or reductions of emissions is inadvisable, illogical, or damaging to global mitigation goals.

On July 31, 2024, the International Accounting Standards Board (IASB) published a consultation document proposing eight examples to illustrate how companies apply IFRS® Accounting Standards when reporting the effects of climate-related risks and other uncertainties in their financial statements.[25]

In March 2023, the IASB added to its work plan a project to explore targeted actions to improve the reporting of the effects of climate-related risks in financial statements. These examples[26] were developed as part of this project and in response to strong demand from stakeholders, particularly investors, who expressed concerns that information about the effects of climate-related risks in financial statements was insufficient or appeared to be inconsistent with information entities provide outside the financial statements, particularly information reported in other general-purpose financial reports. The IASB expects that the published illustrative examples would help to improve the reporting of the effects of climate-related and other uncertainties in financial statements and strengthen the connection between financial statements and other parts of a company's reporting, such as sustainability disclosures.

These are the eight illustrative examples:[27]

- Example 1—Materiality judgments leading to additional disclosures (IAS 1/IFRS 18)
- Example 2—Materiality judgments not leading to additional disclosures (IAS 1/IFRS 18)
- Example 3—Disclosure of assumptions: specific requirements (IAS 36)
- Example 4—Disclosure of assumptions: general requirements (IAS 1/IAS 8)
- Example 5—Disclosure of assumptions: additional disclosures (IAS 1/IFRS 18)

- Example 6—Disclosure about credit risk (IFRS 7)
- Example 7—Disclosure about decommissioning and restoration provisions (IAS 37)
- Example 8—Disclosure of disaggregated information (IFRS 18)

The IASB has collaborated with members of the International Sustainability Standards Board (ISSB) and its technical staff to develop the examples. The IASB seeks feedback from stakeholders on the published examples, and the comment period is open until November 28, 2024. The received feedback will be reviewed by the IASB to decide whether to proceed with the proposed illustrative examples to accompany IFRS Accounting Standards.

The Securities and Exchange Commission (SEC) has launched a defense in court against litigations challenging the Final Rule on Enhancement and Standardization of Climate-Related Disclosures for Investors.[28]

The SEC had exercised its discretion to stay the climate disclosure rule in April 2024 after petitions seeking review of the Final Rules were filed in multiple courts of appeals between March 6 and March 14, 2024. On August 5, the SEC filed its response brief[29] with the Eighth Circuit Court to defend its position on the rule. In its brief, the SEC has argued that it has the statutory authority to adopt the rule, that the SEC has satisfied the Administrative Procedure Act (APA) and other applicable requirements in adopting the rule, and that the rule comports with the First Amendment.

The SEC makes the following comments in its brief while defending its position that disclosure of climate-related risks that have materially impacted or are reasonably likely to materially impact the business is important to investors' investment and voting decisions.[30]

1. The SEC highlights that, "as with other risks, climate-related risks—and a public company's response to those risks—can significantly affect a company's financial performance and position."
2. The SEC has recognized that many companies already make disclosures regarding climate-related risks; however, it states that "existing disclosures are inconsistent, difficult to compare, and often boilerplate."
3. The SEC notes that "petitioners attack a strawman" in challenging the rule. It reiterates that the "case is not about climate change or environmental policy; it is about protecting investors."
4. The SEC emphasizes that the rule does not "determine national environmental policy or dictate corporate policy."
5. The SEC argues, "petitioners contend that the Rules require issuers to offer their opinions about climate change. Instead, the Rules require issuers to disclose factual information about particular risks to their business."
6. The SEC reminds that the Securities Act and the Exchange Act authorize it to mandate the disclosure of information that it determines to be "necessary or appropriate in the public interest or for the protection of investors"—without limitation to "financial information."
7. The SEC also argues that it has followed a "rigorous notice-and-comment process" for the rule and addressed the concerns raised in the comments and modified the proposed rule "to make the required disclosures more useful to investors and less costly."

The SEC concludes its response by asking the court to remand and not vacate the rule in its entirety if the court determines that the SEC did not adequately consider an issue or explain its choices; and to sever any provision of the rule that the court determines to be unlawful.

Multiple amicus briefs have also been filed in support of the rule after the SEC's filing of the response brief.

On August 15, 2024, the National Association of Insurance Commissioners (NAIC) adopted a Financial Condition for revisions in Risk-Based Capital (RBC) Structure.[31]

Starting from the end of 2024 through 2026, insurers will be required to disclose the impact of climate-related risks on the modeled losses for the threat of hurricane and wildfire. Insurers have two choices to provide their response regarding the approach used: time-based or frequency-based. When following either approach, there should be no changes to book of business, reinsurance strategy, or total insured value (TIV) inflation over the projected time horizon.

In the **time-based** impact modeling approach, insurers should use Representative Concentration Pathways (RCP) projections to model the impact for 2040 and 2050 separately under two time horizons. Insurers can use climate conditioned catalogs from a commercial catastrophe bond (CAT) model vendor or develop their own climate risk model.

In a **frequency-based** impact modeling approach, insurers should consider both a 50% and a 10% increase in the frequency of major hurricanes (Category 3 and higher, focusing on wind losses) and all wildfire events. Insurers should use the same models and assumptions that were used while developing the insurer's catastrophe risk charge (RCAT).

The revisions in RBC structure were incorporated after the American Property Casualty Insurance Association (APCIA) submitted a proposal to NAIC's Capital Adequacy Financial Condition Task Force to revise the RBC framework. The proposal was led by Steve Broadie, vice president of APCIA, to enhance the RBC structure to address the evolving challenges posed by climate change. It was submitted on August 2, 2024. The proposal called for revisions to Property/Casualty RBC Blanks, Instructions, and the RBC Formula. The justification for change is supported by the Solvency Workstream of the Climate & Resiliency Task Force, which has been exploring the development of climate scenario analysis. The proposal was intended to assist domestic regulators in discussions with insurers that may face higher risk levels for these perils.

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Additional Deloitte US perspective on climate risks

For additional insights, please see our ongoing series on how climate risks are shaping US financial regulatory initiatives and the impact these developments may have on the financial services industry and the broader economy:

- Deloitte 2023 CxO Sustainability Report
- 2024 financial services industry outlooks
- Ingraining sustainability in the next era of ESG investing
- The CIO's call to action: Driving an environmentally sustainable tech agenda to accelerate organizational change
- Climate change risk digest | Deloitte US
- Center for Regulatory Strategy | Deloitte US

Endnotes

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