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Autorité fédérale de surveillance des marchés financiers FINMA
Autorità federale di vigilanza sui mercati finanziari FINMA
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FINMA Guidance 01/2023

Developments with regard to the management of climate risks

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Contents

1 Background

The impacts of climate change and the various endeavours to contain them entail multifarious financial risks for financial institutions. FINMA has pointed out these risks on numerous occasions in recent years.[1]

FINMA has also explained that climate risks (e.g. in the form of physical risks, transition risks, or legal and reputational risks) do not form a separate risk category but should instead be understood as risk drivers for existing risk categories. Accordingly, financial institutions have an obligation under applicable law to identify their significant climate-related financial risks as part of their risk management processes. These risks must then be adequately managed and disclosed.

Addressing climate risks presents specific challenges for financial institutions and supervisory authorities. There is considerable uncertainty surrounding the materiality of climate-related financial risks and the time horizon within which such risks can be expected to materialise. Climate policy, and hence the specific transition paths to be taken by the economic sectors, is also subject to a very high degree of uncertainty. There are also challenges in the area of methodologies and data, which are currently making it more difficult to assess and measure climate risks.

The climate risks can be expected to materialise sooner or later and this will also impact upon financial institutions. The physical effects of climate change are already apparent today and will continue to increase.[2] The ongoing global climate debate illustrates that a disorderly transition to a low-carbon economy is certainly possible and this carries additional risks. Consequently, adopting a wait-and-see approach would also be unjustifiable in the financial market.[3] On the contrary, implementing adequate measures to address sustainability risks will be an important factor for ensuring success, as the Federal Council’s latest sustainable finance measures also illustrate.[4]

This Guidance is intended to raise awareness among banks and insurers on the matter of climate-related financial risks. To this end, FINMA makes reference to relevant international developments and underscores its expectation that supervised institutions establish adequate climate risk management that not only takes account of currently recognised practices but is also aligned to their particular risk profile.

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[1] See, for example, FINMA Risk Monitor 2019 and FINMA Annual Report 2020.

[2] Working Group II contribution to the IPCC Sixth Assessment Report (AR6): Impacts, Adaptation and Vulnerability, Summary for Policymakers, 2022

[3] FSB Roadmap for Addressing Financial Risks from Climate Change, 2022 progress report, July 2022

[4] Federal Council Report “Sustainable finance in Switzerland – Areas for action for a leading sustainable financial centre, 2022–2025”, 16 December 2022

2 Work by international standard-setting bodies on managing climate risks

In the past few years, international bodies in the financial sector have conducted in-depth analyses of climate-related financial risks as a matter of priority. The Network for Greening the Financial System (NGFS) has expeditiously developed specific recommendations for addressing climate risks based on initial good practices. The standard-setting bodies BCBS[5] and IAIS[6] investigated the mechanisms by which climate change impacts the financial market and evaluated the classification of these risks on the basis of their minimum standards. With respect to supervision, both BCBS and IAIS concluded that climate risks should be regarded as "risk drivers" and that their existing frameworks[7] are generally broad and flexible enough to capture climate risks.[8] Hence, they do not consider that any revisions to their frameworks are currently required. However, the possibility of future adaptations to more effectively capture climate-related financial risks is not ruled out at the present time.

Accordingly, both BCBS and IAIS also expect banks and insurers to manage their climate risks effectively – in the same manner as applies to all other risks – including in areas such as governance, risk management or disclosure. To promote a uniform supervisory practice concerning climate risks, both standard-setting bodies have published recommendations and guidance. In some cases these are fairly general in nature, but in other cases they contain very specific recommendations for how supervisory authorities can integrate climate risk considerations into supervisory practice based on the existing frameworks.

In 2021, the IAIS published an application paper[9] aimed at supporting supervisory authorities in their efforts to incorporate climate risk considerations into their supervision of the insurance sector and promoting a globally consistent approach. It provides additional guidance and examples of good practice in relation to key principles such as Supervisory Review and Reporting (ICP 9), Corporate Governance (ICP 7), Risk Management (ICP 8 and 16), Investments (ICP 15) and Disclosures (ICP 20). The IAIS has also indicated that it will make changes to ICP Guidance, which will aim to clarify

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[5] Basel Committee on Banking Supervision (BCBS)

[6] International Association of Insurance Supervisors (IAIS)

[7] This comprises: for BCBS: Core principles for effective banking supervision (BCPs) and Supervisory review process (SRP) and for IAIS: "Insurance Core Principles".

[8] BCBS, "Principles for the effective management and supervision of climate-related financial risks", June 2022, p. 1 / www.iaisweb.org > Activities and Topics > Climate risk (as of 19 January 2023)

[9] IAIS Application Paper on the Supervision of Climate-related Risks in the Insurance Sector (May 2021)

how climate risks can be specifically taken into account in relation to specific principles within its framework.[10]

The BCBS is currently conducting a holistic assessment to determine the extent to which climate-related financial risks can be taken into account as part of the Basel framework in the areas of regulation, supervision and disclosures. In June 2022, the BCBS published the "Principles for the effective management and supervision of climate-related financial risks".[11] Alongside recommendations for supervisory authorities, these new principles also contain specific recommendations for banks in the areas of corporate governance, internal control framework, capital and liquidity adequacy, risk management process, monitoring and reporting, comprehensive management of credit, market, liquidity, operational and other risks, as well as scenario analysis. These recommendations do not form part of the BCBS's minimum standards. However, the BCBS expects the principles to be implemented promptly and will be monitoring the implementation work. Furthermore, in December 2022, the BCBS provided further guidance in the form of a set of 'frequently asked questions', as part of the BCBS minimum standards. This is intended to facilitate a uniform interpretation of the existing Pillar 1 standards in relation to climate risks.[12]

3 FINMA's expectations for the management of climate risks

In view of the state of international discussion and the increasing consolidation of a uniform supervisory practice, FINMA expects supervised financial institutions to proactively engage with the current guidance and recommendations issued by international bodies. The above-mentioned publications show how the various challenges presented by climate risks can be specifically addressed and which practices are internationally regarded as useful in this respect. Furthermore, FINMA expects supervised institutions to seriously consider best practices in the market that would be relevant for them – depending on their risk profile and business model. Thus, for example, market-based initiatives in the area of sustainability and climate risks provide useful practical foundations.

In relation to climate risks, supervised institutions are also called upon to critically scrutinise their instruments and processes and, where necessary, to develop these further in a forward-looking manner and adapted to their particular risk profiles. As the practical obstacles associated with evaluating climate risks (data basis, measurability, etc.) are progressively removed, it is

[10] See www.iaisweb.org > Activities and Topics > Climate risk (as of 19 January 2023).

[11] BCBS, Principles for the effective management and supervision of climate-related financial risks, June 2022

[12] BCBS, Frequently asked questions on climate-related financial risks, 8 December 2022

expected that financial institutions will also gain an improved capacity to assess and effectively mitigate climate-related financial risks. Only in this manner will supervised institutions ensure that they are able to optimally identify, evaluate and adequately manage their material climate-related financial risks.

4 Supervision of climate risk management at supervised institutions

FINMA began participating actively in international work on managing climate risks at an early stage. In further developing its practice, it draws guidance from the work of the standard-setting bodies and it also shares their general understanding regarding the classification of climate risks as risk drivers for the existing risk categories. FINMA is committed to developing effective supervision of the supervised institutions' climate risk management and to aligning its supervisory activity to international good practices. This means, in particular, that it will evaluate the international practices and recommendations of the standard-setting bodies in each case and decide upon the extent to which it will put these into effect in its supervisory work.

FINMA already integrates climate-related financial risks into its supervisory activity in a strategic, proportionate and risk-based manner. In doing so, FINMA relies on the applicable provisions of supervisory law. In view of the rapidly changing nature of this issue, FINMA makes annual enhancements to its supervision of climate risk management at banks and insurers; in doing so, it is currently focusing in particular on the institutions in FINMA categories 1 and 2. In the case of large institutions, tools such as supervisory discussions, surveys and also, where necessary, on-site supervisory reviews are deployed. In addition, FINMA is also gathering useful initial experiences in the area of climate scenario analysis. In the future, FINMA intends to generally intensify its supervision of the measures institutions are taking to address climate risks and it will expand this to cover a larger number of institutions, while always having due regard to the principle of proportionality. Furthermore, FINMA will assess the extent to which it is necessary to collect relevant data for the purposes of supervision in the area of climate risks.[13]

[13] FSB, Supervisory and Regulatory Approaches to Climate-related Risks - Final report, October 2022

5 Outlook

Based on its supervisory experiences, and in line with relevant international developments, FINMA will also refine its expectations concerning the management of climate-related financial risks at supervised institutions, and will issue more detailed specifications where this is appropriate and necessary. It is intended that setting specific supervisory expectations will provide clarity for the supervised institutions in terms of how the general requirements can be applied in relation to aspects such as governance, risk management or internal controls relating to climate risks. In doing so, FINMA will generally endeavour to adopt – as it does for all risk drivers – a proportionate approach that will be applied uniformly across all sectors and which will take account of differences between the banking and insurance sectors, as well as the respective recommendations of the IAIS and the BCBS.