May 2020

Governance and management of climate-related risks by French banking institutions: some good practices

CONTENTS

Preliminary remarks

This document builds on the work carried out by the *Autorité de Contôle Prudentiel et de Résolution* (French Prudential Supervision and Resolution Authority) since 2016 on the risks associated with climate change under provision V of Law No. 2015-992 of 17 August 2015 on energy transition for green growth. More specifically, it follows the publication, in April 2019, of an issue of *Analyses et Synthèses* dedicated to "banking groups facing climate change"[1]. This publication contained recommendations addressed to banking institutions and supervisors. Institutions, in particular, were invited to "adopt the sector's best practices" while supervisors were at the same time called to encourage institutions to factor in the risks associated with climate change "[...] by promoting the dissemination of good practices among institutions." The publication also mentioned two themes:

(i) the integration of these risks into banking institutions' internal governance and risk management frameworks;

(ii) the development of both risk analysis tools and climate change scenarios.

In response to these recommendations, the ACPR launched two working groups in July 2019. With particular regard to governance and climate risk management, these recommendations stemmed from a two-fold assessment. On the one hand, the surveys conducted by the ACPR showed that banking groups progressed at an uneven pace in relation to the integration of climate change risks into their governance. Indeed, in some institutions, the Corporate Social Responsibility approach, which focuses solely on the institution's reputational risk, remained dominant. On the other hand, the ACPR noted that institutions would generally benefit from implementing more effectively the strategic orientations associated with climate change, from an operational standpoint, and from complementing the integration of the resultant risks into their usual risk management framework.

The good practices identified in this document derive from interactions with the nine banking institutions[2] that participated in the survey conducted by the ACPR in 2018, as well as with the French Banking Federation (*Fédération Bancaire Française*). They have been reviewed by the Climate and Sustainable Finance Committee of the ACPR ("*Commission Climat et Finance Durable*" – CCFD) during the meeting held on the 20th of February 2020, and were submitted then

[1] ACPR, "French banking groups facing the risk associated with climate change", Analyses et synthèses No. 101, April 2019. https://acpr.banque-france.fr/les-groupes-bancaires-francais-face-au-risque-climatique

[2] BNP Paribas, Crédit Agricole Group, BPCE Group, Société Générale, Crédit Mutuel Group, Banque Postale Group, HSBC France, *Agence Française de Développement* (French Development Agency) and *Caisse des Dépôts et Consignations* (French Deposits and Consignments Fund).

to the restricted College of the ACPR[3]. The final approval by the CCFD occurred on the 30th of April 2020 through a written procedure.

The working group dedicated to the governance of climate change risks met four times between September and December 2019. These good practices ultimately represent the ACPR's view of the integration of the risks associated with climate change in the institutions' governance. In this document, the emphasis is placed on the consideration of climate risk by banking institutions as a financial risk. Thus, the good practices mentioned within it should be considered as a step forward towards the progressive integration of all the environmental[4], social and corporate governance risks, in accordance with international and European work, and in line with their materiality in terms of financial stability.

Purpose

The purpose of this document is to encourage the dissemination of good practices, whether it be:

(i) in banking institutions which, partly due to a business model that is, at first glance, less sensitive to risks related to climate change, have started later than others to consider climate-related risks;

(ii) in more "advanced" banking institutions that wish to improve their governance arrangements and strengthen their operational implementation.

These suggested lines of approach are addressed to all banking institutions authorised in France – thus including institutions that are classified as "less significant"– that wish to start integrating or step up their approach to integrating climate risks. Each institution is therefore invited to consider these good practices in a proportionate manner, i.e. taking into account the importance of its exposures to financial risks arising from climate change and the specificities of its business model and internal governance.

The ACPR also wishes to draw attention to the fact that, under Article 98(8) of Directive EU 2013/36 (as amended by Directive EU 2019/878 – "CRDV"), the European Banking Authority has been mandated to issue, by June 2021, a report on the possible inclusion of ESG risks in the Supervisory Review and Evaluation Process (SREP). At the same time, the European Central Bank could publish its supervisory expectations in the course of 2020. In this context, good practices can help institutions prepare for these future developments.

If this document attempts to be consistent with the applicable legislative corpus, and, in this particular case, with the European Banking Authority's guidelines on internal governance, the approaches suggested in this document are laid down on an indicative basis, and are therefore non-binding. Furthermore, the evolving nature of both the regulatory context and market practices in their inclusion of climate risks implies a regular reassessment of their consistency with these developments.

The lines of approach presented for consideration are not exhaustive either. Banking institutions are therefore invited to take into account all the relevant publications by the European Banking Authority and the European Central Bank, as well as those of international fora such as the central banks and supervisors' Network for Greening the Financial System, (NGFS); the Basel Committee on Banking Supervision (BCBS) or the Financial

[3] Session of the restricted College of the ACPR held on the 21st of February 2020

[4] Environmental risks include, but are not limited to, risks associated with climate change. As an example, they include risks associated with the loss of biodiversity or the water cycle management, as defined by the action plan of the European Commission on sustainable finance "financing policy for sustainable growth" of 8 March 2018 (p.2): *"environmental considerations refer to attenuation of climate change and adaptation to it, as well as to the environment in general. […] These considerations concern, for example, air and water pollution, the exhaustion of natural resources and the loss of biological biodiversity".*

Stability Board (FSB). The ACPR's work is, inter alia, included in the framework of the NGFS's work. The ACPR's part constitutes a contribution consistent with the guidelines set by the NGFS.

Moreover, in addition to qualitative measures, this document encourages banking institutions to incorporate metrics quantifying their risks into their risk management framework associated with climate change. However, even though this objective should be pursued, the insufficient maturity of existing methodologies and the limited availability of the necessary data may lead institutions to use qualitative measures as an intermediate step. Similarly, as set out in the definitions section, climate risks focus on an uncertain but far more distant horizon than generally chosen for the strategic and financial planning of institutions, which complicates further their integration into established processes. This may imply an adjustment period for institutions in order to achieve this goal. While the perspective in this document is focused on the management of financial risks associated with climate change, it is important to recall the broad, transverse and multifactorial climate issues for both the financial sector and for economic and social stakeholders in general. Thus, the opportunities provided by such an evolution are not ignored and institutions are encouraged to take advantage of them, especially if they increase the resilience of the institution's business model.

This risk-based perspective is ultimately more targeted than the broader one focused on the non-financial performance of banking institutions. That broader perspective focuses on criteria other than the economic and financial ones in the assessment of environmental and social corporate behaviour - including that of banking institutions. The development of "green" finance and financial products is particularly included in this perspective.

Definitions

The good practices detailed below concern the restricted scope of risks associated with climate change that are themselves a component of the "ESG" (environmental, social and governance) risks. However, the suggested lines of approach can be adapted and generalised to fit the overall ESG risk, in a proportionate manner and in accordance with the assessment of the materiality of its exposures associated with other components.

This paper focuses on the risks arising from the exposure of financial institutions and/or the financial sector to the physical or transitional risks caused by, or related to, climate change. The definitions of physical risk and transition risks are taken from the NGFS's first full report and listed below:

- **Physical risk**. Physical impacts include the economic costs and financial losses resulting from the increased severity and frequency of extreme weather events related to climate change (such as heatwaves, landslides, floods, fires and storms) as well as more progressive long-term climate changes (such as rainfall level changes, extreme weather variability, ocean acidification, rising sea level and average temperatures).
- **Transition risk**. The impacts of the transition are linked with the adjustment process towards a low-carbon economy. The level of carbon emissions must eventually achieve carbon neutrality to prevent the escalation of climate change. The emission reduction process is likely to have a significant impact on all sectors of the economy by affecting both the value of financial assets and corporate profitability. Even though a strong case can be made for urgent action, an abrupt transition could have an impact on financial stability and, more broadly, on the economy.

The issue of *Analyses et Synthèses* that was published in April 2019 distinguished the **liability risk** from the physical and transition risks.

However, consistently with international work, especially the work carried out by the NGFS, the risks associated with the emergence of legal proceedings related to climate change for governments, businesses and investors, for instance liability risks, should be understood as a subset of physical and transition risks.

While the risks associated with climate change are likely to be an aggravating factor for types of existing risks, it is important to note that, given its specificities, the nature of climate change can warrant adaptations to the established risk management organisation, and must be integrated into the latter.

The distinctive features of climate change include in particular:

(i) an impact of considerable extent and magnitude liable to affect a wide variety of geographical areas and economic sectors asymmetrically (across geographies and industries), potentially exacerbating all types of financial risks;

(ii) highly probable realisation of those risks over an uncertain horizon and effects that are difficult to precisely anticipate;

(iii) effects on a medium to long-term scale, which depend on uncertain, short-term decisions. This further complicates the inclusion of those risks.

Banking Institution Strategies to face Climate Risks

<u>First principle</u>: taking into account its pivotal role, the strategy of institutions, and more specifically its conception by the management bodies, and its implementation within the institution as well as the tools deployed to ensure its monitoring, should fully integrate the risks associated with climate change.

This section examines the development of a strategy to address climate risks (design, sectoral policies), its implementation within banking institutions (implementation at subsidiary level, communication policy) as well as monitoring tools (indicators, links to risk appetite). It should be emphasised that the institutions' strategy to address climate risks should be expressed in terms of financial risks beyond reputational or opportunity concerns. In addition, institutions should pursue the aim of using scenario analyses related to climate risk to clarify and inform financial planning. In time, the aforementioned financial planning should be coordinated with the strategy implemented to address climate risks.

A. The elaboration of a climate risk strategy

1. Whether they are addressed explicitly and separately or through the overall assessment of ESG concerns, the potential negative consequences of climate change on the strategic positioning and financial risks of the institution should be explicitly identified by the management bodies, with the involvement of the board of directors in its supervisory function, as well as the executive committee in its implementation role of the institution's strategy. In this respect, climate risks should be subject to strategic guidelines and be explicitly entrusted to one or more members of the executive committee with sufficient knowledge in this field, and relying on recognised internal or external expertise.

2. The planning horizon for the strategy should take into account the specific features of climate change risks. Institutions are encouraged to ensure that the strategic orientations are consistent with -or at least refer to- international agreements such as the Paris Agreement (2015), the relevant national strategies such as the *Stratégie Nationale Bas Carbone* (SNBC, the French low carbon emissions national strategy), and the international scientific consensus such as the assessments of the experts of the Intergovernmental Panel on Climate Change (IPCC).

3. The indicators selected by the executive committee for the monitoring and implementation of the climate risk strategy designed, in particular, by the risk management function in liaison with CSR (Corporate Societal Responsibility) function, in line with the allocation of responsibilities as defined in Section II, should be reviewed by the board of directors in its supervisory role. These indicators (e.g. outstanding amounts on certain carbon activities or the greenhouse gas emissions they entail) and the strategy in general should be consistent with risk management arrangements as defined in Section III, including risk appetite assessment and framework.

4. When defining performance or monitoring indicators, once the broad guidelines for climate risk have been agreed on, banking institutions could also call upon the expertise of specialised structures such as think tanks, research centres or non-governmental organisations.

5. The management bodies involved in climate risk issues should be regularly informed of available internal and external analyses. To this end, a dedicated committee relying on advice from internal or external experts, e.g. from the scientific community, could assist the management bodies in defining and monitoring a climate risk strategy. The chairperson of that dedicated committee could, in particular, assist, intervene or report to the board of directors as regards the implementation of this strategy with a frequency that has yet to be determined, but at least once a year.

6. When scenario analyses or studies pertaining to climate risks are carried out, the strategy adopted by banking institutions should be informed and revised by formally taking into account associated findings. It could also take into account the relevant external work for institutions.

7. In relation to the “duty of vigilance”, institutions should continue to ensure the consistency of their strategy for climate risk and their outsourcing strategy or policy, including by considering the nature and activities of their external service providers.

B. Deployment and implementation of the strategy within the institutions

8. In order to monitor the implementation and achievement of the objectives associated with the climate risk strategy across the whole group as well as in all business lines, robust and verifiable performance indicators should be defined taking into account available data. The level of these indicators should be determined by the executive committee and reviewed by the executive board in its supervisory role. The methodology selected for the measurement of these indicators should be validated by relevant committees. Therefore, institutions should specify the internal governance in charge of that validation. They could for instance rely on the committee mentioned in Section II.

9. Existing or specialised committees such as the one that is tasked with supporting the management bodies in developing a climate risk strategy could monitor implementation across the group, for instance through a reporting system, involving representatives of subsidiaries (or affiliates) at the appropriate seniority.

10. The institutions’ climate risk strategy should be subject to a dedicated internal communication plan, the elements of which could include a description of the impacts on banking activities, a description of performance and monitoring indicators, the reference to major international agreements and national policies, as well as any relevant information on sectoral policies.

11. Finally, the implementation and achievement of the objectives set out in the strategy for climate change management should be supported by the appropriate budgetary and human resources.

C. The tools for the climate risk strategy

12. The sectoral policies defined and implemented by institutions are one of the components of the deployment of the selected climate risk strategy and should explicitly reflect the latter. They should include specific criteria, especially respecting the identification of the covered activities and associated counterparties, in order to allow for the regular monitoring of compliance by competent bodies. Where considered relevant with regard to the adopted strategy, they could include quantitative targets for business volumes with the identified counterparties over a specified horizon.

13. The definition of sectoral policies related to climate risk should involve all relevant decision-making bodies and functions: the executive committee and, depending on the practice established within the institution, the relevant business lines for the practical development of such policies and the board of directors in its supervisory function. The specialised committee(s) relying on internal and/or external expertise on climate issues could assist the management bodies.

14. The sectoral policies of institutions should both be regularly examined by the executive committee in the framework of a periodic review of the climate risk strategy, and be reviewed by the board of directors in its supervisory role, including from the angle of the identification of new economic activities to be covered.

15. Credit policies in relation to the criteria for assessing the credit risk associated with climate change, referred to in Section III, should be consistent with the sectoral policies as defined above, for instance with regard to the involvement of their customers in major greenhouse gas (GHG) emitting industries, and their interaction with the criteria defining the entry into a business relationship.

16. Incentive schemes consistent with the strategic guidelines on climate risk could be put in place. In particular, the variable remuneration of senior management and business line managers involved in climate issues could take into account one or several indicators related to these strategic objectives as well as those included in the risk appetite statement (see Section III).

The Internal Organisation of Banking Institutions to face Climate Risks

Second principle: the internal organisation of institutions, both in terms of the allocation of responsibility over all business lines, and in terms of the structuring of climate risk control, is critical in order to ensure their effective management, in line with the institutions' strategic orientations.

The commitment of credit institutions to addressing climate risk requires the definition of a strategy and an appropriate governance to design and implement associated broad principles. This will require identifying all stakeholders and defining their responsibilities, role and degrees of involvement. The next step is then to target all relevant functions and their interaction with respect to the implementation of this governance framework. In this context, institutions should particularly rely on both the risk management and the compliance functions, supported by the CSR function as needed. Managing climate risks also requires, at each level (business lines, operational, comitology, supervision, and management), staff that is both appropriately trained for this type of risk and in sufficient number. Lastly, like any risk, the risks related to climate change will need to be subject to regular review and reclassification, which can be applied to already existing bodies and procedures.

A. Allocation of responsibilities in managing climate-related risks

17. Concerning climate risks, the responsibilities of the various functions involved in this topic should be identified and clarified. The respective responsibilities should be clearly defined and the strategic importance of climate risks should be explicitly stated. This allocation of responsibilities should at least be included in a reference document such as a mission statement.

18. In this respect, the risk management function, considering its resources and expertise, should play a key role in the operational implementation of the climate risk strategy. Given its ability to suggest axes for improvement for the strategy associated with climate issues in line with the expectations of stakeholders, the CSR function could support the risk management function in the development of the strategy's deployment, analytical and decision-making tools. The functions thus involved could rely on the expertise of all relevant business lines and functions.

19. The Compliance function, in liaison with the CSR function depending on the institution's practices, should ensure that banking institutions take into account the legal and reputational risks pertaining to the climate, bearing in mind their commitments to abide by various standards, directives, charters, or codes of conduct on the subject. Within a context of increasing stakeholder attention to compliance with these commitments, the compliance function should ensure that these issues are integrated into the processes that fall within its responsibility.

20. Both the organisational structure and the allocation of financial and human resources should reflect the allocation of climate risk responsibilities within the institution. The reinforcement of the staff tasked with climate-related issues, as well as the resources required for the implementation and deployment of tools dedicated to the analysis and management of climate risks, could be scheduled over the course of several years, in line with the increasing importance of managing these risks.

21. Within the various functions involved, including the risk function, a reference person should be identified and appointed for climate risks related matters, hereinafter referred to as the “climate risks point of contact". The functions involved could be staffed with one or more persons, in particular the point of contact mentioned in this point, whose competence and knowledge are recognised in climate-related matters, especially in terms of professional experience and/or academic training.

22. In support of the executive committee, a committee responsible for climate risk matters and for the coordination of the whole implementation process for the climate risk strategy should be formed by the institution on an ad hoc basis, or on the basis of an existing committee. This committee, which would meet at regular intervals, could be composed of members of the executive committee, as well as the head of risk management, the head of compliance, the head of the CSR function, and heads of operational business lines and support functions.

23. Generally, committees that are potentially or clearly concerned by climate risks should be explicitly identified by banking institutions. Consequently, these risks should be added to the responsibilities of the relevant committees. A dedicated committee -separate from the one mentioned above- could also be formed to deal with arbitrage for the most complex transactions, which have implications for climate risks, especially between the risk and compliance functions.

B. The organisation of climate risk control

24. As the first line of defence, business lines staff should be trained to take into account climate risks in their management of business relationships. Each important business line could have one or more climate risk correspondents whose role would be to link that business line with the risk function as well as other functions involved. The training effort should involve all relevant staff.

25. Concerning permanent control (the second line of defence), procedures should include the monitoring of compliance with the defined policy for climate strategy and related risks, including the achievement of the defined objectives and indicators, as well as the analytical tools used. The risk and compliance functions would be expected to fulfil this role.

26. Concerning periodic control (the third line of defence), audits should progressively include a climatic risk component and, over time, risk-related missions could be scheduled according to a timeline that is consistent with the materiality of the risk.

27. While drafting their Annual Report on Internal Control (“*Rapport Annuel de Contrôle Interne*”, RACI), banking institutions could integrate and develop a climate risk component for each type of risk concerned.

Risk Management Tools to address Climate-related risks

<u>Third principle:</u> the material risks induced by climate change justify their full integration into the financial risk management framework of institutions, especially their risk appetite framework, but also the mobilisation of all qualitative tools, and, as far as possible, quantitative tools, in order to allow for a thorough assessment of these risks.

Banking institutions should be able to apprehend and measure their exposures to climate change risks through the integration of these risks into risk-analysis tools, in compliance with the risk appetite framework. However, data on climate change risks is still not included within the centralised databases of banking institutions, especially due to their unavailability or fragmented framework, which complicates the assessment of risks. Therefore, efforts should be made by institutions in order to allow for the identification, the collection and the centralisation of the necessary data. Similarly, the specificities of climate-related risks (in terms of horizon and uncertainty regarding the magnitude of these risks) imply additional methodological difficulties in the assessment of counterparties. All these aspects may lead institutions to focus, in a first step, on the exposures which could be the most important and sensitive ones.

28. In order to manage effectively the risks associated with climate change and their inclusion in the definition and validation of the strategic guidelines of institutions in compliance with their risk appetite, the management bodies, within both their oversight and executive functions, should be able to rely on a comprehensive assessment of their financial impacts.

29. Risk appetite statements should describe the impact of the risks associated with climate change for any relevant type of risk. This includes at least the credit, market and operational risks.

30. Taking into account the long-term financial interest of banking institutions, risk appetite statements should include risks associated with climate change, including key indicators related to their exposures to climate risks to which limits and thresholds should be associated. Therefore, in addition to qualitative measures, institutions should endeavour to use quantitative indicators. Those indicators should be linked to those mentioned in Section I. Where the degree of maturity of the indicators developed by the institution does not allow for it, institutions should at least rely on the use of qualitative objectives or indicators.

31. Banking institutions should manage the financial risks related to climate change through their risk management frameworks for existing risks, in compliance with the risk appetite level approved by their board of directors. To this end, institutions should identify, measure, monitor and manage key indicators related to their exposure to climate risk. All reference documentation associated with risk management should be amended accordingly.

32. Taking into account the specificities of the risks associated with climate change, banking institutions should collect and centralise the data needed to assess the risks posed by counterparties in order to provide management bodies with an aggregated and comprehensive view of these risks and their evolution. As regards the transition risk, institutions should in particular aim at systematically collecting data on the carbon footprint of the businesses they finance. As regards the physical risk, institutions should, based on available data, seek to identify the share of counterparties' assets located in vulnerable geographical areas that are more subject to that risk.

33. Banking institutions should consider a range of quantitative and qualitative tools to explicitly measure, manage and monitor the evolution of their exposure to financial risks arising from climate change on the different types of risks identified in their risk appetite statement.

34. Institutions should assess the current and potential future impact of the risks associated with climate change, especially the transition risk and the physical risk, on any counterparty and at all stages of the business relationship. This approach should at least be qualitative (e.g. through a dedicated questionnaire giving rise to a rating), strive to be quantitative, and include assessments covering the strategic planning horizon.

35. Institutions should pursue the objective of integrating into their internal capital adequacy assessment (ICAAP) processes their material exposures affected by the risks associated with climate change on any relevant risk type and over an appropriate horizon considering the specific characteristics of those risks.

36. Given the specificities of climate risks, a prospective approach is encouraged. In this context, the analysis of climate scenarios is a useful tool for quantifying an institution's potential exposure and to transition and physical risks. In the case of credit institutions, this approach could be used to assess its resilience and vulnerabilities in the long term in relation to its business model. Where appropriate, scenario analyses should pay particular attention to whether the market transition towards a low-carbon economy is orderly or not.

37. The risk committee should review its risk assessment tools regularly, and at least once a year, monitor the evolution of exposures, paying particular attention to their risk appetite framework, and decide to adopt documented schemes on exposure mitigation and remediation measures where necessary. The risk committee should also ensure that risk reports enable the management bodies to have an aggregated view of financial risks related to climate change in order to make the appropriate decisions.

38. Due to its historical expertise in the field of environmental, social and governance (ESG) issues, the presence of a member of the CSR function in charge of climate matters could be required at the meetings of the risk committee for the reviews mentioned in the previous paragraph.

Disclosure of climate-related risks

<u>Fourth principle</u>: in order to ensure both a better understanding and a better integration of climate-related risks, banks should disclose their strategy, their organisation, and their risk management mechanisms with regard to climate change.

In order to ensure a better understanding and a better consideration of climate risks, banks should disclose their strategy, organisation, and risk management arrangements to address climate change. As emphasised by international work such as the one conducted within the framework of the Task Force on Climate-Related Financial Disclosure (TCFD), facilitating the access to climate-related information is of paramount importance in order to enable financial actors to assess the risks associated with climate change.

39. Disclosure towards all the relevant stakeholders could contain a stock-take of the strategy, of the commitments announced and their monitoring, the goals to be achieved, the deployed resources and the obtained results with respect to the risks associated with climate change. These information could be in the Non-Financial Performance Statement of institutions ("*Déclaration de Performance Extra-Financière*", DEPF).

40. Considering that risks associated with climate change are material, unless otherwise demonstrated by the bank, institutions should publish information pertaining to these risks under the Pillar III regulatory framework. This publication could take place under a desired form and frequency - but at least once a year. It should also cover all business activities related to the climate-related risks strategy.

41. With respect to items subject to climate-related disclosure, institutions could rely in particular on the principles and recommendations provided by the Taskforce on Climate-related Financial Disclosure (TCFD) and the European Commission's non-binding guidelines on non-financial information (supplement on reporting climate-related information).