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To: Superintendent Jeremy Rudin
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Re: OSFI Consultation to Promote Preparedness and Resilience to Climate-related Risks

The Canada Climate Law Initiative (CCLI) supports the Office of the Superintendent of Financial Institution's (OSFI) efforts to embed climate-related financial risk in its prudential oversight of federally-regulated financial institutions (FRFI) and federally-regulated pension plans (FRPP).[1] Our submission offers some insights on the policy issues underpinning this effort. The CCLI is a collaboration of the faculties of law at the University of British Columbia and York University examining the legal basis for corporate, financial and pension fiduciaries to consider, effectively manage, and report on climate-related financial risks and opportunities. We work with 70 Canadian Climate Governance Experts and 15 scholars across Canada, and are partners in the global Commonwealth Climate and Law Initiative.

We have four recommendations that are within OSFI's legislative mandate and will enhance public confidence in Canada's financial system. OSFI should consider the long gestation/high-impact risks of climate change that can have a material impact on the financial condition of organizations that it supervises. Most immediate is that OSFI requires the data to monitor capital and liquidity risks associated with climate change such that it can effectively utilize its oversight and early intervention authority. In this respect, as international standards are developing, OSFI can take a stepped approach to its protection of the financial system, recognizing the rapidly evolving standards and information on climate-related financial risk.

1. As part of its prudential oversight, OSFI should require FRFI and FRPP to report on how they are currently managing exposures to climate-related risks and embedding them in their risk management, governance, strategy, and targets and metrics as part of their annual disclosure of capital adequacy and solvency risk.

2. OSFI should work towards defining common metrics for FRFI and FRPP to report on climate-related risk management as part of their annual disclosure of capital adequacy and solvency risk, with careful attention to developing international standards so that data are comparable. Once the metrics are established, FRFI and FRPP should be required to report data on that basis.

3. OSFI should require FRPP to disclose governance, risk management, strategy, and targets and metrics regarding climate-related risks and opportunities in their statements of investment policies and procedures.

4. Once OSFI has collected the standardized data, it should assess its capital adequacy and liquidity requirements based on the identified risks and make any adjustments needed.

We also attach, as part of CCLI's submission, our recent report on the insurance sector and climate-related financial risks. It provides a detailed answer to OSFI's first question on how climate-related physical and transition risks affect insurers, focusing on both the assets and liabilities sides of the balance sheet, with application in many instances to deposit-taking institutions. The risks vary across different types, sizes, regions, and timelines, and the report should provide some insights for OSFI in terms of the scope of risks and their relationship to solvency risk. It also offers a number of governance strategies in terms of climate resilience and management of operational and accounting risks.

1. **As part of its prudential oversight, OSFI should require FRFI and FRPP to report on how they are currently managing exposures to climate-related risks and embedding them in their risk management, governance, strategy, and targets and metrics as part of their annual disclosure of capital adequacy and solvency risk.**

OSFI's mandate is to protect the safety and soundness of Canada's financial system, including protection of deposit-holders, policyholders, and pension plan beneficiaries. Given the unprecedented financial risks that climate change poses and the commitment by Canada to transition to net-zero carbon emissions, it is essential that OSFI, as Canada's prudential regulator, is safeguarding the stability of the financial system. To accomplish this task, it requires the data to make informed decisions regarding risk detection and early intervention. While there is growing convergence on international standards, in the immediate term OSFI should require FRFI and FRPP to report on how they are currently managing exposures based on the four broad categories recommended by the Taskforce on Climate-related Financial Disclosures (TCFD);[2] specifically, to report on their risk management, governance, strategy, and targets and metrics as part of their annual disclosure of capital adequacy and solvency risk.

Climate-related risk is part of prudential risk because it can affect the solvency of FRFI in a number of ways. A recent study reports that the net-zero emissions needed to stabilize the climate requires acceleration in use of non-carbon energy sources and a rapid decline in the global share of fossil fuels in the energy mix.[3] Canada's FRFI are major lenders and investors in carbon-intensive industries such as energy, transportation, and commercial real estate; and absent effective management of the risks, there is danger of being caught off side from the diminution of their asset portfolio values, stranded assets, or from financial counterparties shifting their lending or investment choices. For example, increasing insolvencies in the oil and gas sector in Canada can negatively affect FRFI portfolio values.[4] Decreased capital may affect the FRFI's ability to conduct business, and failure to effectively manage the transition to net-zero carbon emissions could affect the solvency of FRFI heavily invested in these sectors.[5] This risk is more acute in Canada because oil sands are a high-cost marginal producer; and it is no surprise that foreign energy firms have been selling off their investments in Canada to focus on lower risk/cost investments elsewhere. Much of the capital raised by high carbon-emitting sectors is from institutional investors in securities markets; however, there can be second round effects on FRFI from broader economic damage, as well as risks associated with the lending that will still be required during the transition to net-zero carbon emissions.

The Basel Committee on Banking Supervision's Task Force on Climate-related Financial Risks observed that climate-related financial risks potentially impact the safety and soundness of individual financial institutions and could pose potential financial stability concerns for the financial system.[6] The Geneva Association, an international think tank on insurance risk management, has observed that climate change is a significant risk and insurers have a fiduciary duty to enhance the value of their assets so that they remain solvent, which poses constraints on the industry's investment strategies.[7] FRFI will need to demonstrate to global markets that they are serious about effectively managing climate-related risks and opportunities.

The Financial Stability Board (FSB) reports that if banks were to suffer widespread losses as a result of the crystallization of physical risks, it could cause an increase in their leverage and reduction in their lending prompted by a need to preserve their solvency, which can amplify shocks to the real economy, resulting in larger losses for banks, further reducing bank solvency.[8] The FSB also reports that widespread manifestation of climate-related risks that give rise to an increase in the credit and liquidity risk of financial institutions might lead to a widespread deterioration in financial-sector solvency such that losses due to the materialization of climate-related risks for one financial institution could result in deterioration of its solvency that then leads to losses for other financial institutions.[9]

As institutional investors, FRFI and FRPP are also vulnerable to litigation for failure to manage climate-related risks and opportunities. The failure of directors and officers to consider and manage climate-related risks to the FRFI's business or investments may give rise to liquidity or solvency risks where investors or other stakeholders seek compensation from the FRFI and/or directors personally for breach of disclosure obligations or failure to prudently manage assets. In terms of indirect effects, the value of FRFI's investment assets may be impaired if investee companies unsuccessfully defend litigation and monetary damages are awarded to investors.[10] In turn, these risks develop into reputational and market risks if consumers and investors perceive a failure by the FRFI to effectively manage climate-related risks and opportunities. Another solvency risk is where the assets of the FRFI are located in jurisdictions outside of Canada. While OSFI and the Canadian Deposit Insurance Corporation, as Canada's bank resolution authority, have memoranda of understanding with other regulatory authorities regarding insolvency resolution, there is a risk that once a FRFI is financially distressed due to climate impacts, countries will ringfence valuable assets; thus data on these vulnerabilities are key to early intervention.

Quantifying and managing climate-related risks is therefore an important public policy issue. An obstacle to ensuring that OSFI fulfills its mandate is the lack of standardized data on climate-related financial risks across FRFI and FRPP over which OSFI has prudential oversight. OSFI's current assumptions regarding capital adequacy and liquidity may not capture the impacts of climate risk in the future. Our view is that additional information is required to ensure that the Own Risk and Solvency Assessment for insurers and the Internal Capital Adequacy Assessment Process for deposit-taking institutions capture climate-related financial risks as they manifest. A core function of OSFI is risk detection and early intervention and the only way it can exercise that core duty is to ensure it receives reliable quantified data on the risks and their management.

Canada's FRFI and FRPP must already manage material financial risks, and climate change has now emerged as a material risk. Prudential regulators globally recognize that financial institutions need to be proactive and forward-planning as climate risks accelerate. OSFI should be moving towards standardized data requirements for entities over which it has prudential oversight, but CCLI recognizes that some temporary obstacles remain to achieving a common disclosure template for purposes of OSFI's oversight.

There will be a time lag before there is international consensus on sustainable accounting standards, and arguably, assessing climate-related financial risk as part of prudential risk cannot wait. As an immediate first step, OSFI should require FRFI and FRPP to report on how they are currently managing exposures to climate-related risks and embedding them in their risk management, governance, strategy, and targets and metrics as part of their annual disclosure of capital adequacy and solvency risk. Using these TCFD-aligned categories is an important start that allows flexibility as international standards are set.

OSFI can also take guidance from existing International Financial Reporting Standards (IFRS) regarding accounting standards that already require FRFI to quantify climate-related financial risk. IFRS already require disclosure of climate-related risks in financial accounting and disclosure. In November 2020, the IFRS Foundation published guidance, the *Effects of climate-related matters on financial statements*, which states that material climate-related financial information should be reported under IAS (international accounting standard) 1 Presentation of Financial Statements, IAS 2 Inventories, IAS 12 Income Taxes, IAS 16 Property, Plant and Equipment, IAS 38 Intangible Assets, IAS 36 Impairment of Assets, IAS 37 Provisions, Contingent Liabilities and Contingent Assets, IFRS 7 Financial Instruments: Disclosures, IFRS 9 Financial Instruments, and IFRS 13 Fair Value Measurement.[11] In addition to this specific disclosure, IFRS advises that it is important for organizations whose financial position or financial performance is particularly affected by climate-related matters to provide overarching disclosure.[12]

OSFI's use of the TCFD framework and IFRS guidance will allow it to enhance supervisory oversight now while still leaving room for evolving accounting standards, and allow FRFI to transition from qualitative disclosure to quantitative reporting that supports meaningful management of the risks and opportunities that the transition to net-zero emissions presents. CCLI believes that OSFI already has a well-functioning early intervention system in which it advises FRFI of areas of concern it has identified at an early stage, including material deficiencies in capital and liquidity or issues of concern regarding management of the FRFI, intervening effectively so as to minimize losses to depositors or policyholders.[13]

Until standardized data requirements can be developed, OSFI's immediate reporting requirements will also be enhanced by the five principles of disclosure that OSFI developed under Basel III for domestic systemically important banks. These principles offer immediate guidance on implementing more effective disclosure of climate-related solvency risks. Adjusted specifically to climate-related financial risk, the following five principles should inform OSFI's disclosure requirements:

i. Disclosures should be clear and be presented in a form that is understandable and communicated through an accessible medium in an integrated form.
ii. Disclosures should be comprehensive, describing material climate-related financial risks across all aspects of the FRFI and FRPP, both qualitative and quantitative information on the processes and procedures for identifying, measuring and managing those risks, supported by relevant underlying data and information submitted to OSFI, with a continuing obligation to report significant changes in risk exposures between reporting periods and responses to these changes by management, such that OSFI can assess choices in risk tolerance and management and intervene at an early stage if required.
iii. Disclosures should be meaningful by highlighting the most significant current and emerging risks and how those risks are managed, linking risk to the balance sheet or income statement.
iv. Disclosures should be consistent over time to enable identification of climate risk profile trends across all significant aspects of business and asset management, with clear disclosure on changes in accounting and disclosure methodologies year over year.

v. Disclosures should be comparable across FRFI, allowing meaningful comparisons of business activities, prudential metrics, risks and risk management between FRFI and across jurisdictions.[14]

2. OSFI should work towards defining common metrics for FRFI and FRPP to report on climate-related risk management as part of their annual disclosure of capital adequacy and solvency risk, with careful attention to developing international standards so that data are comparable. Once the metrics are established, FRFI and FRPP should be required to report data on that basis.

To build on the immediate reporting required for prudential oversight, OSFI should develop common metrics for FRFI and FRPP to report on climate-related risk management as part of their annual disclosure of capital adequacy and solvency risk, aligning with developing international standards so that data are comparable. While a number of accounting standards and disclosure frameworks have been developed, they are converging internationally under the TCFD framework and accounting guidance under IFRS established by the International Accounting Standards Board.

The TCFD recommendations for identifying and managing climate-related financial risk though governance, risk management, strategy, and targets and metrics regarding climate-related risks and opportunities, allow scaling up from qualitative analysis to quantified reporting and management.[15] The FSB reports that over 1,500 organizations globally have endorsed the TCFD framework, including financial institutions with $150 trillion in assets under management (AUM).[16] Most Canadian FRFI and FRPP use IFRS and the International Accounting Standards Board clearly states that existing accounting rules require climate to be considered where material. The 2020 IFRS guidance offers clear direction on accounting for material climate risk.[17] In addition, the IFRS Foundation's current efforts to develop international sustainability reporting standards within the existing IASB/IFRS governance structure includes examining a prototype climate-related financial accounting standard proposed by a number of global standard setting organizations,[18] which is likely to result in convergence of accounting standards. Thus the TCFD governance framework and IFRS accounting standards offer direction to OSFI regarding information it needs to assess to meet its prudential oversight obligations.

These converging standards indicate that FRFI and FRPP can improve their identification, management and reporting of climate-related risks by conducting assessments of their investments, products and services, operations, and supply and distribution chains for exposure to climate-related financial risks; embed climate-related risk assessments into their risk appetite assessment processes, quantitative risk impact processes, and capital adequacy and solvency assessments; and report to OSFI on a basis that is sufficiently granular that OSFI can make informed decisions in its prudential oversight of the FRFI and FRPP.

The International Association of Insurance Supervisors (IAIS), of which OSFI is a member, identified effective practices of prudential supervisors to encourage and/or require insurers to utilize TCFD disclosures, supplemental guidance, and scenario analysis to design best practices and set supervisory objectives.[19] Scenario analysis can assist in stress-testing the FRFI's and FRPP's financial resilience to severe but plausible outcomes from various trajectories of global warming. Key to this effort will be modelling that captures the potential future risk exposures, offering pathways to their management. The IAIS reports that adoption of the TCFD will help address inconsistencies in how climate-related information is communicated to the market, integrating climate within mainstream financial disclosures.[20]

CCLI believes that in order for OSFI to determine whether FRFI and FRPP are in sound financial condition and meeting regulatory and supervisory requirements, it needs to standardize the information it seeks from these organizations, generating both entity-specific data and comparative data that will allow it to undertake scanning of the sector and assess systemic risks. Disclosures must be relevant and targeted. As highlighted in our attached report on the insurance sector, there are a range of transition and physical risks that vary depending on the type of financial institution; and in order to ensure that the financial system is resilient, OSFI needs to be able to assess those data to ensure that climate-related financial risks are recognized as a core part of prudential risk, and where necessary, intervene at an early stage to preserve viability where possible.

We also support OSFI's pilot initiative with the Bank of Canada[21] and the insights it will generate on loss-absorbing capacity and solvency risks across a range of severe but plausible scenarios. Important will be how scenario analysis can translate into metrics that make sense for capital and liquidity calculations. In terms of FRFI taking a forward-looking approach to identifying and managing material risks to their businesses and investments, the TCFD offers a framework for strategic planning, assessment of risk appetite, and governance mechanisms to build quantification of risks, managing and measuring processes towards net-zero emissions. Scenario testing could prove a valuable tool and OSFI should be requiring disclosure on the projected outcomes of various scenarios. For distributing FRFI, there may be a concern about forward-looking financial information disclosure to investors. A safe harbour provision that protects projections where they are based on reasonable and prudent analysis is likely to aid in the thoroughness and utility of such scenarios because well-reasoned, evidence-based forward-looking information would be protected should the actual outcomes vary. Key also is to link executive compensation to specific climate-related risk management objectives.

OSFI should continue to be involved in development of international consensus on how to measure these risks in sufficient granular detail for purposes of capital and liquidity requirements and OSFI has a key role in implementing the international consensus here in Canada. We appreciate that FRFI and FRPP need to take reasonable risks in their financial decisions, having careful eye to their prudential obligations. OSFI's role of "trust but verify" makes sense, but in order to verify, OSFI needs to collect the data necessary to assess resilience and solvency even as standards continue to develop.

3. OSFI should require FRPP to disclose governance, risk management, strategy, and targets and metrics regarding climate-related risks and opportunities in their statements of investment policies and procedures.

OSFI supervises FRPP and pooled registered pension plans and intervenes where necessary to protect pension plan members and beneficiaries from loss, recognizing that plan administrators are responsible for the plan's management and that pension plans can experience financial difficulties that can result in the reduction of expected benefits. OSFI's supervision of FRPP includes an expectation that trustees, administrators, and other pension fiduciaries will meet legislative requirements; the requirements set out in their statement of investment policies and procedures (SIPP); and their obligations to invest and manage assets prudently to meet the pension promise for multiple generations of plan beneficiaries. In order to effectively exercise that supervision, OSFI requires information on how climate-related financial risk is being embedded directly in the FRPP's governance, risk management, strategy, and targets and metrics regarding climate-related risks and opportunities. Where the FRPP delegates investment decisions to investment managers, the engagement mandate should make clear the need to identify and manage climate-related financial risks and require the investment manager to generate the required data that the FRPP can submit to OSFI to allow it to exercise its prudential supervision.

Public and private pension funds have a critically important role in the shift to a sustainable net-zero carbon economy as major investors and providers of financial security to Canadian employees during their retirement. In November 2020, the Chief Executive Officers of Canada's eight largest pension fund investment managers, representing CA$1.6 trillion AUM, issued a statement recognizing the need for a post-COVID-19 recovery that puts sustainability and resilience at the core, seeking standardized TCFD climate-related disclosure from portfolio companies.[22] As part of Climate Action 100+, more than 500 investors with $47 trillion AUM are pressing the largest greenhouse gas (GHG) emitting investee companies to strengthen their climate-related disclosures in line with the TCFD recommendations.[23] A number of major pension plans in Canada are taking leadership and OSFI could apply their approaches to the smaller pension plans under its oversight.

As part of OSFI's prudential oversight of FRPP, SIPP should include disclosing how FRPP are establishing a governance framework to address climate-related financial risks. The Pension Benefits Standards Regulations, 1985, s 7.1 should be amended to require the SIPP to identify the FRPP's approach to climate-related governance, risk management, strategy, and targets and metrics. That information would then be reviewed by OSFI in its assessment of prudential risks and the effectiveness of management of climate-related risks and opportunities. The Ontario pension regulation offers a precedent for implementing this policy,[24] and it aligns with the recommendations of the federal government's Expert Panel on Sustainable finance.[25]

The UK Pensions Regulator has stated that the net-zero transformation requires climate factors to be fully integrated into mainstream financial decision-making across all sectors and asset classes.[26] The UK government has enacted legislation requiring pension plans to disclose climate risks and governance based on the TCFD framework.[27] The UK *Pension Schemes Act 2021* authorizes regulatory requirements on the trustees or managers of pension schemes to ensure there is effective governance with respect to the effects of climate change.[28] Proposed new regulations for pension schemes adapt the TCFD recommendations to make them relevant to trustee decision-making structures. For example, trustees are required to have oversight of climate-related risks and opportunities; must set climate-related targets and report the scheme's carbon footprint by calculating GHG emissions of the investment portfolio; and must publish a report on their governance of climate risk.[29] As of 2019, trustees of pension plans with 100 or more members are required to set out in their statement of investment principles (SIP) their policies on stewardship and on material environmental, social and governance considerations, including climate change, and must publish their SIP by 1 October 2021.[30]

CCLI wants pension funds to invest sustainably so that they have the assets to meet the pension promise given to their plan members and beneficiaries. Embedding their management of climate-related risks and strategy in their SIPP is an important step forward.

4. Once OSFI has collected the standardized data, it should assess its capital adequacy and liquidity requirements based on the identified risks and make any adjustments needed.

Canadians rely on OSFI as the federal prudential oversight authority to protect their savings, pensions, and life and health and other insurance policies. The capital adequacy and liquidity requirements are a function of risks and OSFI needs the data in order to assess any needed adjustments in its requirements. CCLI acknowledges that without clear granular measurement metrics, one cannot set capital and liquidity requirements for those risks in the public frameworks. Canada must keep pace with other countries in management of climate-related financial risks to its financial institutions.[31] OSFI needs to be able to assess

climate-related risk exposures and strategies that identify climate-related risk appetite commensurate with the nature, size, complexity and risk profile of the FRFI and FRPP.

OSFI's commitment to implementing the Basel III Framework is important to preventing systemic shocks to the financial system.[32] OSFI's proposed new Capital Adequacy Requirements Guideline to better align capital requirements with risk;[33] Leverage Requirements Guideline to align with revised capital requirements and safeguard institutions against excessive borrowing; and the Liquidity Adequacy Requirements Guideline to improve risk-sensitivity and to ensure that institutions are holding enough cash or other liquid investments to provide for contingent liquidity demands and support continued lending, particularly during periods of financial stress, illustrate the need for Canada to continue to align financial policy with international developments, including standardized operational risk capital rules and closely aligning capital requirements with risk.[34] It also makes sense to tailor the capital and liquidity requirements for small and medium-sized deposit-taking institutions.[35] The requirements should encapsulate all risks to which the FRFIs are exposed, including climate risks that have long gestation periods before they crystallize.

Climate-related risks must be considered in the current capital framework for Canada's FRFI and as noted above and in the appended report, a number of these risks are not currently captured. Climate-related financial risks should be incorporated more specifically in internal capital adequacy and solvency assessments, and OSFI should issue more guidance embedding climate-related financial risk into its risk assessment processes. Disclosure of both climate-related financial risks as they are developing and management of those risks are key to OSFI's prudential oversight. CCLI appreciates that there is complex and systemic interplay between physical and transition risks, with both direct and indirect ripple effects that could destabilize Canada's financial system. OSFI's prudential supervisory role is a key part of Canada's capacity to manage risks to the financial system in the transition to net-zero GHG emissions.

In conclusion, we support OSFI's efforts to promote preparedness and resilience to climate-related financial risks. It is important that OSFI takes steps now to ensure FRFI and FRPP are reporting baseline metrics, working towards embedding international standards as they develop.

On behalf of CCLI, sincerely,

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NOTES

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[3] Science Advisory Group of the UN Climate Action Summit 2019, *United in Science,* World Meteorological Organization (22 September 2019), United in Science 2020 | World Meteorological Organization (wmo.int).
[4] See for example, Insolvency Insider, "Oil & Gas Insolvency Filings", (March 2021), Industry: Oil and Gas (insolvencyinsider.ca).
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[11] IFRS, *Effects of climate-related matters on financial statements*, (20 November 2020), at 1, effects-of-climate-related-matters-on-financial-statements.pdf (ifrs.org) [hereafter IFRS].
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[13] See the discussion in Janis Sarra, "A Bridge Over Troubled Waters — Resolving Bank Financial Distress in Canada", *Annual Review of Insolvency Law 2017* (Toronto: Carswell, 2018) 255-341 and Janis Sarra, "Flotsam, Financing and Flotation: Is Canada 'Resolution Ready' for Insurance Company Insolvency?", Annual Review of Insolvency Law 2018 (Toronto: Carswell, 2019) 973-1068.
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[26] The UK Pensions Regulator, "Climate change strategy" (7 April 2021), Climate change strategy | The Pensions Regulator
[27] *Pension Schemes Act 2021,* UK Public General Acts, 2021 c 1, Royal Assent on 11 February 2021, Pension Schemes Act 2021 (legislation.gov.uk) [hereafter *Pension Schemes Act 2021*]. UK Government, "Taking action on climate risk: improving governance and reporting by occupational pension schemes – response and consultation on regulations" (27 January 2021), Taking action on climate risk: improving governance and reporting by occupational pension schemes - GOV.UK (www.gov.uk) [hereafter UK Government, Taking Action].
[28] Section 124, *Pension Schemes Act 2021, ibid,* adding section 41A to the *Pensions Act 1995:* They must disclose risks arising from steps taken because of climate change by governments or otherwise and opportunities relating to climate change. The

statute authorizes regulatory requirements that include (a) reviewing the exposure of the scheme to risks of a prescribed description; (b) assessing the assets of the scheme in a prescribed manner, including their contribution to climate change (ss 4); (c) determining, reviewing and, if necessary, revising a strategy for managing the scheme's exposure to risks of a prescribed description; (d) determining, reviewing and, if necessary, revising targets relating to the scheme's exposure to risks of a prescribed description; (e) measuring performance against such targets; (f) preparing documents containing information of a prescribed description (ss 3). The regulations may require the trustees or managers of the scheme to take into account different ways in which the climate might change, and different steps that might be taken because of climate change (ss 5).

[29] UK Government, Taking Action, note 27 .

[30] *Ibid.*

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