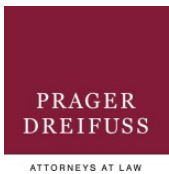


## Developments in the management of climate risks in Switzerland

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By *Guy Deillon* March 02, 2023



### **Guy Deillon of Prager Dreifuss considers the new FINMA Guidance 01/2023 and its impact on financial institutions**

The financial sector is facing an unprecedented challenge in the form of climate change. Financial institutions can play a crucial role in managing the risks and opportunities associated with climate

change, and regulators around the world are increasingly recognising the need for them to do so. The Swiss Financial Market Supervisory Authority (FINMA) is no exception.

FINMA has recently issued new guidance, [FINMA Guidance 01/2023](#) (the Guidance), drawing attention to relevant developments in the area of climate-related financial risk management. In the Guidance, FINMA reiterates its expectation for financial institutions to establish an appropriate climate risk management framework based on recognised practices.

## Background

Climate change presents a wide range of risks and opportunities in the financial sector.

- Physical risks, such as destruction from extreme weather events or rising sea levels, can have direct impacts on the value of assets and the stability of financial systems;
- Transition risks, such as policy changes or technological disruptions, can affect the long-term viability of companies and industries; and
- There are reputational risks associated with environmental and social impacts, as well as the risk of litigation related to climate change.

The financial sector is also a key player in the transition to a low-carbon economy. Financial institutions can allocate capital to low-carbon investments, incentivise companies to reduce their carbon emissions, and help to develop new financial products that support the transition.

International developments are taking place in climate-related financial risk management. International standard-setting bodies are developing concrete recommendations and guidance for dealing with such climate risks. The Basel Committee on Banking Supervision (BCBS) and the International Association of Insurance Supervisors (IAIS) expect banks and insurance companies to manage their climate risks effectively – in the same manner as applies to all other risks – including in areas such as governance, risk management and disclosure.

FINMA has been closely monitoring developments in the management of climate risks in the financial sector for some time. In 2019, FINMA mentioned the subject in its annual [Risk Monitor report](#), which focused on the need for financial institutions to identify and manage climate risks. Climate risks have been part of the annual FINMA Risk Monitor report ever since.

Since 2021, FINMA has required banks and insurance companies in supervisory categories 1 (extremely large, important and complex market participants) and 2 (very important, complex market participants) to disclose qualitative and quantitative information relating to their management of climate-related financial risks as part of their regular reporting. Based on the reports published in 2022, FINMA issued a new [Guidance 03/2022](#), highlighting a number of areas of improvement for future climate reporting.

The new Guidance builds on these publications and provides more detailed direction on how financial institutions can manage climate risks in practice. In the Guidance, FINMA reiterates its expectation that supervised institutions establish an adequate framework for managing climate risks that is adapted to the respective risk profile of the institution. In this context, FINMA expects the supervised financial institutions to engage proactively with the recommendations and guidance provided by international bodies as well as relevant best practices in the market and to develop their tools and processes further where necessary.

For its part, FINMA will continue to develop its supervisory practice for assessing the management of climate-related financial risks. In doing so, it will take into account the work of the standard-setting bodies. Where appropriate and necessary, FINMA will specify what it expects from supervised institutions in terms of climate risk management.

## **Key components of the Guidance**

The Guidance is divided into three main sections:

- Recognition of international standards;
- FINMA expectations for financial institutions; and
- Supervision activities.

### **Recognition of international standards**

FINMA reviews the work of the main standard-setting bodies in the area of climate risk. In the Guidance, FINMA first recognised the work performed by the Network of Central Banks and Supervisors for Greening the Financial System (NGFS). The NGFS is a global coalition of central banks and supervisors that aims to support the transition to a sustainable economy by mobilising the financial sector.

The NGFS has made a number of recommendations to financial institutions and regulators to help to manage climate risks and support the transition to a low-carbon economy. Some of the key recommendations include:

- Integrating climate risks into financial stability monitoring and supervision – financial institutions should identify, measure and manage the physical, transition and liability risks associated with climate change to ensure the resilience of the financial system to these risks;
- Enhancing the availability of climate-related information – financial institutions should disclose information on their exposure to climate-related risks and opportunities, and should consider using the [Task Force on Climate-related Financial Disclosures](#) framework to structure their disclosures;
- Supporting the transition to a low-carbon economy – financial institutions should allocate capital towards low-carbon investments, incentivise companies to reduce their carbon emissions, and help to develop new financial products that support the transition;

- Strengthening the resilience of financial institutions to climate risks – financial institutions should conduct scenario analysis to assess the impact of different climate scenarios on their business models and balance sheets, and should develop stress-testing scenarios that take into account climate risks; and
- Promoting international cooperation on climate-related financial risks – financial regulators and supervisors should work together to develop common approaches and standards for managing climate risks in the financial sector, and to promote the sharing of best practices and data.

In the Guidance, FINMA also summarises the work of the BCBS and the IAIS, as standard-setting bodies. In a nutshell, these bodies examined the ways in which climate change affects the financial market and assessed the categorisation of these risks according to their minimum standards. In terms of supervision, both organisations determined that climate risks should be considered as "risk drivers" and that their existing frameworks are generally inclusive and adaptable enough to encompass these risks. As such, no revisions to their frameworks are deemed necessary at this time, although the potential for future adjustments to better address climate-related financial risks is not entirely dismissed.

Accordingly, the BCBS and the IAIS anticipate that banks and insurance companies will manage their climate risks with the same level of effectiveness as they do with all other risks, encompassing areas such as governance, risk management, and disclosure.

To facilitate a standardised supervisory approach towards climate risks, both standard-setting bodies have released guidances and recommendations. While some of these are quite broad in nature, others provide detailed suggestions on how supervisory authorities can incorporate climate risk assessments into their frameworks.

For insurance companies, FINMA mentioned that in 2021, the IAIS released [an application paper](#) with the aim of supporting supervisory authorities as they integrate climate risk considerations into their supervision of the insurance sector and encourage a consistent global approach. The paper provides further guidance and practical examples with regard to key principles, such as Supervisory Review and Reporting (Insurance Core Principle, or ICP, 9), Corporate Governance (ICP 7), Risk Management (ICPs 8 and 16), Investments (ICP 15), and Disclosures (ICP 20).

Additionally, FINMA mentions that the IAIS will update its ICP guidance to clarify how climate risks can be specifically addressed in relation to individual principles within its framework.

With respect to banks, FINMA states that the BCBS is undertaking a comprehensive evaluation to determine the extent to which climate-related financial risks can be integrated into the Basel Framework across 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”](#).

In addition to recommendations for supervisory authorities, the BCBS principles provide recommendations for banks to manage and supervise climate-related financial risks. The principles cover several areas, including:

- Corporate governance;
- Internal control frameworks;
- Capital and liquidity adequacy;
- Risk management processes;
- Monitoring and reporting; and
- Comprehensive management of credit, market, liquidity, operational and other risks.

While the recommendations do not form part of the BCBS minimum standards, the organisation expects prompt implementation and will monitor progress. The principles are intended to be part of a holistic assessment to determine how climate-related financial risks can be integrated into the Basel Framework for regulation, supervision, and disclosures.

Additionally, in December 2022, the BCBS issued further guidance in the form of **a set of frequently asked questions**, as part of the minimum standards of pillar one. This is intended to facilitate a uniform interpretation of the existing standards with regard to climate risks.

## **FINMA's expectations**

FINMA's Guidance contributes to the discussion on climate-related risks by reminding Swiss financial institutions that such risks should be encompassed within their overall strategies, risk management framework, internal control systems, and governance structure. To ensure adequate climate risk management, FINMA highlights three regulatory priorities:

- Proactive engagement with the guidance and recommendations issued by international bodies, particularly the IAIS and the BCBS (as mentioned above);
- The incorporation of market best practices that are relevant to the institution's risk profile and business model; and
- Thorough scrutiny of the instruments and processes used, which should be forward-looking and tailored to the institution's risk profile where necessary. As obstacles to evaluating climate risks are progressively removed, financial institutions are expected to gain better capacity to assess and mitigate these risks effectively. According to FINMA, this is necessary to ensure that institutions can identify, evaluate, and manage their material climate-related financial risks.

The requirement to integrate climate-related risks into traditional risk management frameworks applies not only to large banks and insurance companies (categories 1 and 2), but also to smaller institutions. FINMA expects these smaller institutions to address climate risks using a proportionate and risk-based approach.

## **Supervision activities**

In the Guidance, FINMA points out that it has already been, from an early stage, actively involved in international efforts to manage climate risks. The regulatory body draws guidance from standard-setting bodies and shares their understanding of climate risks as drivers for existing risk categories. FINMA reiterates that it is dedicated to developing effective supervision of climate risk management and aligning its practices with international standards. This involves evaluating international practices and recommendations and deciding how to incorporate them into its supervisory work.

FINMA incorporates climate-related financial risks into its supervision in a strategic, proportionate, and risk-based manner by relying on the relevant provisions of supervisory law. To keep up with the rapidly changing nature of the issue, FINMA updates its supervision of climate risk management annually, with a present focus on categories 1 (extremely large, important and complex market participants) and 2 (very important, complex market participants) financial institutions. FINMA uses various tools – such as supervisory discussions, surveys, and on-site reviews – for large institutions.

FINMA also gains useful experience in climate scenario analysis. In the future, FINMA intends to intensify its supervision of climate risk measures for a larger number of institutions while ensuring proportionality. Additionally, FINMA announced that it will assess the need to collect relevant data for supervisory purposes related to climate risks.

## **Impact on the Swiss financial sector**

The FINMA Guidance is likely to have a significant impact on the Swiss financial sector. Swiss banks and insurance companies have already made significant progress in managing climate risks, with many of them committing to ambitious climate targets and investing in low-carbon technologies. For example, in its 2021 Climate Risk Report, UBS Group AG cites transition risk exposure in its lending business as \$37 billion (just over 8% of total lending exposure, down slightly from 2019), of which \$265 million is high risk, and physical risk exposure (for example, destruction) as \$25 billion (just over 5.5% of total exposure, down significantly from 2019), of which only \$78 million is high risk. However, the new Guidance will require them to go further and to provide more detailed and transparent information about their exposure to climate risks.

The Guidance is also likely to accelerate the trend towards sustainable finance in Switzerland. In line with the Paris Agreement, the Swiss government has already set a target of net-zero greenhouse gas emissions by 2050, and the financial sector will play a crucial role in achieving this target.

## **Swiss outlook on managing climate risks**

Following a similar approach to the EU, Swiss public companies, banks, and insurance companies will have to report publicly on climate-related risks as part of their annual non-financial report. This reporting will provide transparency on the internal measures taken by these entities to manage climate-related risks.

The management of climate risks is expected to be a key issue for Swiss financial institutions subject to mandatory climate disclosures, as well as other financial institutions, because FINMA expects climate risks to be integrated into strategic discussions and internal risk management processes using a risk-based approach.

The European Central Bank has also communicated its expectations on the topic for EU banks, including categorising climate risks and conducting an impact assessment by March 2023, and fully integrating climate risks into their strategy, governance, and risk management framework by the end of 2023.

FINMA is expected to follow international developments, refine its guidance, strengthen scrutiny, and progressively tighten expectations where necessary.

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**Guy Deillon**

ASSOCIATED PARTNER Prager Dreifuss

Guy is a member of Prager Dreifuss' Corporate & M&A, Venture Capital and Capital Markets teams.

He focuses on domestic and international M&A, as well as private equity transactions. Furthermore, he assists companies in financings as well as on general corporate, stock exchange and capital markets law matters.

Guy's clients benefit from his strong focus on goals and results as well as his high sense of responsibility. His analytical strength and logical approach support his focus on the business perspective and problem solving. He always demonstrates a clear and distinct position in a diplomatic and collaborative spirit.

Guy holds a masters' degree in law from the University of Fribourg and an LL.M. from the Columbia Law School.

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