# Government of Canada: Office of the Superintendent of Financial Institutions

April 12, 2021

Office of the Superintendent of Financial Institutions

Dear OSFI Working Group,

# RE: Navigating Uncertainty in Climate Change: Consultation Response

Corporate Knights and Manifest Climate are pleased to provide you with this joint submission in response to the consultation paper *Navigating Uncertainty in Climate Change* dated January 2021 (the "**Discussion Paper**"). The views represented in this submission are informed by the role our organizations play in the market, which is to comment on, counsel and otherwise support Federally Regulated Financial Institutions (FRFIs) and Federally Regulated Pension Plans (FRPPs) with respect to their responses to climate change and sustainability matters. We believe the focus of our work, and the extensive exposure of our respective organizations to financial markets more generally, enable us to submit an informed response. Links to additional information regarding our respective organizations can be found at the end of this consultation response.

Our consultation response is split into two parts. The first part provides a description and discussion of key principles ("**Principles**") for OSFI's consideration and potential endorsement. The second part responds to each of the Discussion Paper consultation questions. Except as otherwise noted in this response, we use terms as defined in the OSFI Discussion Paper.

**Part I: Key Principles**

1. **Climate risk is a systemic risk that differs from, but impacts, all other risk categories.**

As noted in the Discussion Paper and by others (including FRFIs and FRPPs), climate risk is a systemic risk. It differs from other risks (e.g. market, credit and operational). Climate risk also differs from broader ESG factors. Put differently, climate risk is *sui generis*, impacting most, if not all, other areas of risk. OSFI's approach should, therefore, contemplate a system-wide response. That response must factor in (a) the time horizon for required change, i.e. deep decarbonization efforts in the immediate term (this decade), with transition to net zero by mid-century; and (b) the impact of changes in the climate today that are already adversely affecting sectors and economies (and which are likely to get worse in the future). In other words, a systemic response must be calibrated to allow for, and react to, known and unknown transitional and physical risks and opportunities across the short, medium and long term.

1. **OSFI should act now.**

Acknowledging OSFI's ongoing duty to collaborate with the Government of Canada and other stakeholders, OSFI should assume a leadership role within Canada on climate risk. There are three principal drivers for this.

First, data from FRFIs, FRPPs and, crucially, other jurisdictions, show that early agency action on systemic risk promotes market stability, in that it provides predictability; which in turn allows market participants to assess and model threats, as well as opportunities (as to which see further Principles 5 and 7 below).

Second, early action is possible. Existing frameworks (of which the TCFD is paradigmatic, supported by other initiatives such as PACTA) are available to support OSFI action. These frameworks may not be perfect, but they do provide sufficient foundational support. In particular, the TCFD recommendations urge organizations to consider and disclose how climate change-related risk and opportunities impact their core business and asks how these risks are being managed in an integrated way. This type of systemic transparency should be required of FRFIs and FRPPs. Inaction or delay by OSFI would entail multiple costs and risks. It will lead to individualized responses by FRFIs and FRPPs, which is inefficient from the market perspective (increased costs for participants to develop bespoke responses). It will also lead to an uneven playing field (investors will not be able to compare institutions consistently). And finally, it is more likely to lead to responses by FRFIs and FRPPs that are insufficient to address climate risk. Conversely, the early participation of reporting institutions is likely to accelerate the development of a standardized approach. That is to say, the sooner institutions are required to engage on climate-risk and opportunities, the sooner the market will reach maturity on them. This view informs our recommendations below regarding adoption of the TCFD (see Principle 3 below) and OSFI/industry collaboration on the use of science-based metrics (see Principle 4 below).

Third, OSFI's position directly impacts FRFIs and FRPPs, but also has an indirect and significant impact on entities beyond its remit, e.g. as FRFIs and FRPPs push down reporting obligations onto their own clients. OSFI therefore has the opportunity to have an outsize impact on Canada's overall climate response.

1. **OSFI should support the mandatory adoption of TCFD reporting.**

OSFI should develop mandatory standards for the disclosure of climate risks. Given the widespread adoption of the TCFD by companies and other jurisdictions (as to which see further Principle 7 below), the TCFD should be used as the baseline framework. Regulatory harmonization – which is a topic that is not extensively addressed in the Discussion Paper – is a condition precedent to effective climate disclosure in Canada. OSFI should take advantage of its agency position to effect mandatory disclosure obligations and corresponding regulations to guide OSFI and the institutions it oversees.

The mandatory adoption of public climate-risk disclosure standards should (a) include the obligation to include such disclosures in annual financial reporting, i.e. not in supplementary reports (which would be consistent with the UK approach); and (b) discourage compliance 'by reference', i.e. a reporting entity should not simply provide a table listing where its climate-related disclosures are in different reports; climate disclosures should be located in a single (and preferably consistent) reporting location. In parallel with the adoption of the TCFD, OSFI may also want to mandate specific risk management standards to accelerate maturity in climate-practices, e.g. mandated oversight of climate risk by board level risk committees and/or the mandated development of a climate change risk position statement.

1. **The adoption of standardized taxonomies, methodologies and science-based metrics will require ongoing work and collaboration.**

Notwithstanding the recommendation for OSFI to act now (see Principle 2 above), OSFI should budget for ongoing collaborations with industry to improve climate-risk taxonomies, methodologies and metrics as they apply to FRFIs and FRPPs.

The development of a climate risk taxonomy with definitions that are appropriate to FRFIs and FRPPs will require significant effort and will be an ongoing process. Defining specific climate risks or risk categories in taxonomies and detailing how such taxonomies link to the major risk categories will provide a common language and foundation for climate-related risk identification and assessment.

Most detailed [climate-related taxonomies in development today](https://www.csagroup.org/news/defining-transition-finance-in-canada/) are focused on defining climate opportunities, or on how certain activities contribute to climate change mitigation or adaptation. In other words, they are focused on solutions. Our research has shown that the few published climate-risk taxonomies are usually at a high level. Some list broad categories of climate risk (such as the [TCFD recommendations - table 1 page 10](https://assets.bbhub.io/company/sites/60/2020/10/FINAL-2017-TCFD-Report-11052018.pdf)), simple groupings of climate issues, or blanket statements on how climate risk interacts with principal risks. These taxonomies are generally missing the link between traditional financial risk categories, such as credit risk or model risk.

The development of a climate-risk taxonomy suitable for use with FRFIs and FRPPs presents two main challenges. The first is to sufficiently detail the climate issues such that the financial professionals comprising the three lines of defense, and who have little to no climate training, are able to consistently recognize them. The second is to map these climate issues to the risk categories in use in the applicable institution. OSFI should proactively partner with FRFIs and FRPPs to address these challenges.

The development of appropriate taxonomies will help reveal the need to update certain areas of the existing capital framework that disincentivize green infrastructure investment because of outdated data or assumptions (see further Principle 5 below).

The development of taxonomies will necessarily occur in parallel to the development of methodologies and science-based approaches to metrics that are already building on foundational frameworks like the TCFD. Existing bodies (such as [CBI Taxonomy](https://www.climatebonds.net/standard/taxonomy) and [SBTI](https://sciencebasedtargets.org/)) have developed or are developing methodologies and core exposure metrics, consistent with the TCFD, that will help investors and other stakeholders develop a clear, comparable and consistent understanding of the exposure of any given asset class. We anticipate that capacity constraints are likely to demand prioritization for the OSFI collaboration that will be required. In this context, OSFI should focus on specific asset classes (e.g. equities, real assets and fixed income), mapped across climate impact (e.g. support for climate-related resolutions, climate solutions exposure, carbon intensity and/or global warming potential).

As noted in the COP26 private finance agenda, "every professional financial decision will need to take climate change into account". Achieving this will require significant agency work and industry collaboration (e.g. working groups, etc.).

1. **OSFI should consider updating existing rules and requirements (e.g. prudential penalties) that compromise or delay capital allocation to infrastructure projects that are intended to respond to or address climate-risk.**

This should begin with 'green infrastructure', where existing rules and requirements may be based on outdated assumptions or data. OSFI should consider providing at least moderate relief on regulatory capital requirements related to green infrastructure projects, where this can be done in a responsible way and with oversight to maintain the stability of the financial system. Moody's research default data for infrastructure projects provide an empirical basis to consider such relief. In its 2017 report, [*Infrastructure Default and Recovery Rates*](https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1084940) *1983-2016,* Moody's indicates that total infrastructure debt securities experience substantially low incidence of default. This stability was notably demonstrated in the 2008-09 financial crisis. The Moody's report also indicates that, in aggregate, infrastructure debts are less likely to incur credit losses than non-financial corporate issuers, especially over longer time periods. As one significant Canadian example, Sun Life's infrastructure debt portfolio has had no losses over the past 20 years. Nevertheless, the changes to the Life Insurance Capital Adequacy Test (LICAT) first proposed in 2016 led to a 6% capital charge, up from the previous Minimum Continuing Capital and Surplus Requirements (MCCSR) charge of 2% for unrated infrastructure loans. The development of green infrastructure on the scale required to address climate-risk will require support from all sectors, including innovation in finance. OSFI is in a unique position to promote such innovation.

1. **OSFI should promote opportunities that are coincident with risk.**

The Discussion Paper devotes significant attention to downside risk. This is warranted. However, OSFI should also recognize the opportunity cost of not fully understanding and taking advantage of allocating capital to climate solutions. Climate risk presents novel challenges to FRFIs and FRPPs, but also presents novel opportunities. OSFI messaging that highlights opportunities coincident with risk will help spur innovation in the institutions it oversees.

1. **OSFI should act to ensure right-sizing of climate-risk obligations.**

The adoption of the foregoing recommendations (above) will help OSFI develop a position that imposes appropriate obligations and grants appropriate relief to covered entities. Large institutions should shoulder the heaviest burden, with capacity-building resources afforded to smaller FRFIs and FRPPs.

1. **Canada's FRFIs and FRPPs are both global leaders and globally exposed. That position demands a response that preserves Canada's competitive advantage.**

Although last in our list of recommendations, OSFI's work on climate-related risks must support the existing competitive advantages enjoyed by FRFIs and FRPPs. That means implementing the framework that meets the stated objective (an appropriate response to climate change) without imposing obligations that prejudice FRFIs and FRPPs in a competitive and globally exposed market. Put differently, OSFI should build on the work of other jurisdictions (e.g. the UK and Europe), with appropriate adjustment, as necessary, to account for the Canadian market.

By way of example, the mandatory adoption of the TCFD in other jurisdictions will, given the exposure of FRFIs and FRPPs to the international financial markets in those jurisdictions, effectively compel many FRFIs and FRPPs to adopt the TCFD recommendations. The later adoption of a different framework by OFSI will put FRFIs and FRPPs that have previously adopted the TCFD (and, by extension, all related entities) at a competitive disadvantage.

**Part II: Responses to Discussion Paper Questions**

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| # | | Question | Remarks |
| Climate-Related Risks and their Impact on FRFIs and FRPPs | | | |
|  | | What are your views on the characterization of climate-related risks as drivers of other risks? How do climate-related risks affect FRFIs and FRPPs? Do you have other views on the characterization of climate-related risks set out in this paper? | As noted in Principle 1 above, climate risk is a systemic risk. Put differently, climate risk is financial risk. Climate risk is unique, in that it impacts all other areas of risk. That said, climate change also provides opportunity (see Principle 5 above). Climate opportunities are under-represented in the Discussion Paper. |
|  | | What steps can FRFIs and FRPPs take to improve their definition, identification and measurement of climate-related risks and the impact of these risks? | The development of a consistent, coherent and system-wide response is key. The adoption of the TCFD (see Principle 3 above) and the development of appropriate taxonomies and methodologies (see Principle 4 above) represent the best way for FRFIs and FRPPs to improve the definition, identification and measurement of climate-related risks and to understand, and respond to, the impact of such risks. |
| Ways FRFIs Could Prepare for, and Build Resilience to, Climate-Related Risks | | | |
|  | | Does your organization have, or plan to develop, a climate-related risk appetite and strategy? How does your organization approach setting its risk appetite and strategy? | Not applicable (given our support role to FRFIs and FRPPs). |
|  | | What new or adapted governance structures, policies or processes should FRFIs consider to effectively manage a FRFI's climate-related risks? | FRFIs should adopt and implement the TCFD recommendations (see Principle 3 above), with a further objective of developing industry and sectoral "good" and "best" practices around governance, strategy, risk management and appropriate metrics and targets through experimentation, innovation and transparency to empower climate-smart decision-making. |
|  | | What are the key considerations and challenges related to embedding climate-related risk management in a FRFI's three lines of defense? | As discussed in Principle 4 above, FRFIs continue to face capacity/knowledge challenges (i.e. financial professionals comprising the three lines of defense may have little or no climate training). A second challenge is the consistent mapping of climate issues to risk categories in use in the applicable institution. |
|  | | Is the description of the data challenges presented by OSFI in this discussion paper complete or are there other data challenges that need to be considered? What is the relative importance you would assign to each of these challenges? | The data challenges described in the Discussion Paper broadly reflect the challenges faced by the FRFIs. The inclusion of imprecise climate data in default modelling may adversely impact investors/consumers, particularly where climate models used vary across institutions. The development of separate climate modeling as a default predictor may be warranted in the first instance, without limiting our recommendation – noted in Principle 3 above – that climate-risk related disclosures be included in a reporting entities financial report (i.e. not a standalone report). However, even today there is sufficient data to enable climate-smart decision-making. In other words, existing data challenges are not (or should not be) a defining feature of OSFI's response; at present capacity-constraints and lack of resources (i.e. the ability to ask the right questions) are more significant. |
|  | | If your organization has started to include climate-related considerations in its risk management approaches and tools, please share your experience, including the usefulness and challenges associated with climate-related scenario analysis and stress testing. If not, please describe other processes and controls you have introduced to determine the materiality of climate-related risks and manage exposure to these material risks. | Scenario analysis and stress testing is a useful tool, although its importance should not be overstated (it is one of 11 TCFD recommendations). Scenario analysis will develop over time, and FRFIs who adopt scenario analysis find that at the second and third iteration of analyses they see step-changes in the detail and utility. |
| Ways FRPPs Could Prepare for, and Build Resilience to, Climate-Related Risks | | | |
|  | | What are the key considerations for incorporating climate-related risks into the FRPP's Statement of Investment Policies and Procedures (SIP&P)? | Climate risks should be included in SIPPs. SIPPs should reflect considerations derived from the TCFD recommendations, reflecting the systemic nature of climate risk (see Principle 1 above). |
|  | | For FRPPs where the administrator directly invests in assets, are scenario analysis and stress testing used to assess the pension plan's exposure to climate-related risks? If so, how useful are they? What are some other risk measurement tools that FRPP administrators should consider? | See response to question 7 above regarding scenario analysis and stress testing (with respect to iterative improvements). Scenario analyses and stress tests are important tools for managing climate risks, but other tools remain important. |
|  | | For FRPPs where individual investment decisions are delegated to an investment manager, should consideration be given to climate-related risk management when plan administrators select investment managers? If so, what are the key climate-related criteria for selecting investment managers? If not, why not? | Yes. Selection of investment managers should include climate-related risk management as a consideration. During the selection process, weight should also be given to those managers that (a) have the competence to report climate-risk on an ongoing basis; and (b) demonstrate a culture of climate-competence, i.e. competence that pervades all functions within the organization, not just through an 'ESG' function. The criteria for the selection of investment managers is similar to that that should apply to any corporate fiduciary today, i.e. competence as to climate risk and an ability to implement appropriate risk management tools (e.g. alignment with, and implementation of, TCFD recommendations). |
| Climate-Related Financial Disclosure | | | |
|  | How does your organization currently disclose climate-related risk information? What are the drivers for any voluntary disclosure? | | Not applicable (given our support role to FRFIs and FRPPs). | |
| OSFI's Ongoing Work on Climate-Related Risks | | | |
|  | A challenge OSFI has identified is a lack of a universal climate-related risk taxonomy. Please describe the climate-related risk taxonomy, if any, your organization has developed or adopted? | | See comments at Principle 4 above. | |
|  | Given OSFI's role as the prudential regulator and supervisor of FRFIs and FRPPs, what other work do you think OSFI should consider in relation to climate-related risks? | | As noted in Principle 2 above, OSFI should assume a leadership role within Canada on climate risk. OSFI action to endorse the TCFD and help guide the development of consistent taxonomies will have a direct impact on FRFIs and FRPPs, but will also have an indirect impact on the broader economy. OSFI has the opportunity to play an outsize role by leading on climate-related risks. Done correctly, OSFI's role should advance the global standing of Canadian FRFIs and FRPPs, without imposing unreasonable burden on covered entities (see also Principle 6 above). | |
|  | What are your views on the relative importance of using (1) OSFI's capital framework, (2) supervisory review process, and (3) market discipline to promote FRFI preparedness and resilience to climate-related risks? What factors should OSFI consider when making changes to the design and approach to each of these areas? | | Market discipline, through mandated climate-related financial disclosures, and consistent taxonomies and methodologies, is a first step. That discipline will, in effect, compel covered entities to advance climate-risk assessments (including scenario analysis), which will in turn become more sophisticated and allow additional supervisory review and calibrated capital requirements. There may be discrete items that can be added to existing inputs in the capital framework, and guidance on risk assessment processes is helpful (assuming it is aligned with TCFD), but the imposition of market discipline through mandatory climate-related financial disclosures is a step that will have meaningful results. | |
|  | Are there circumstances where it would be appropriate to factor climate-related considerations in the capital framework beyond what is already reflected in existing inputs in the absence of empirical evidence? What are the pros and cons of such an approach? | | Yes. In order to properly discharge its responsibility to protect financial markets, OSFI should move past the existing scenario of delayed action, and include additional climate-related considerations in the capital framework. Although empirical data may not be comprehensive, there is sufficient information to act now; the imperative is to radically reduce emissions and embrace innovation to stay globally relevant (see Principle 7 above). | |
|  | What factors should OSFI consider in designing its guidance, supervision process and reporting requirements to promote FRPP preparedness and resilience to climate-related risks? | | As noted throughout this response, the application of, and alignment with, the TCFD, and the integration of climate-related risk and opportunities into core business practices, should form the basis of OSFI's guidance, supervision and reporting requirements. | |

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We are available to discuss any aspect of this consultation response, and would welcome the opportunity to present our views and work at your convenience. Additional information on our respective organizations can be found at <https://www.corporateknights.com>, and <https://manifestclimate.com> .

Sincerely,

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| --- | --- |
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