Developments in the Management of Climate Risks

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Key Takeaways

- **The recently published FINMA Guidance 01/2023 underlines the growing importance of including climate risks in the risk management of financial institutions.**
- **FINMA reiterates its stance on climate risks in general as well as on the pertinence of the work undertaken by international standard-setting bodies.**
- **FINMA outlines its expectations towards supervised financial institutions regarding the management of climate risks.**
- **Future quantitative and qualitative enhancements to the supervision of climate risk management are on the horizon.**

Introduction

On 24 January 2023, FINMA published its Guidance 01/2023 on the developments in the field of the management of climate risks. With this guidance, FINMA aims, first and foremost, at raising the awareness on climate risks of both banks and insurers. To this end, three main topics are addressed: (i) the latest international developments in the management of climate risks, (ii) FINMA's expectations towards financial institutions, and (iii) the measures to implement the supervision of climate-risk management into the broader supervisory framework and practice.

However, before addressing the abovementioned topics, FINMA seizes the opportunity to reiterate two of its fundamental views on climate risks more generally.

First, FINMA considers climate risks (consisting of physical risks, transition risks, as well as legal and reputational risks) not as a distinct risk category but as an overall driving factor that exacerbates existing risk categories. Second, FINMA is of the view that climate risks will materialise "sooner or later", and that it thus strongly advocates against a wait-and-see approach and for the implementation of adequate measures to address sustainability risks. In this latter regard, FINMA aligns itself with the Federal Council, who has recently published a report outlining its latest sustainable finance measures.

The Principal Topics of the Guidance

International Developments in the Field of Managing Climate Risks

On the international level, various endeavours have been undertaken both to analyse the impact of climate risks on the financial system and to provide specific recommendations for addressing these risks. In this regard, FINMA particularly highlights the efforts of the Basel Committee on Banking Supervision (BCBS) and of the International Association of Insurance Supervisors (IAIS).

Similar to FINMA's view, both the BCBS and the IAIS generally consider climate risks as driving factors, rather than a risk category per se. Hence, climate risks can be addressed within their established frameworks. The two bodies also concur that banks and insurers, respectively, must indeed address the issue and manage climate risks in an efficient manner – akin to other risks. To further and facilitate uniform supervisory practices, the standard-setting bodies have published recommendations on how supervisory authorities may integrate climate risks into their respective supervisory practices.

Besides their primary objective of ensuring uniform supervisory practices, the recommendations of the BCBS and the IAIS also provide guidance for individual banks and insurers regarding the management of climate risks.

FINMA's Expectations Regarding the Management of Climate Risks

Based upon the two bodies' aforementioned recommendations as well as on the overall international trend, FINMA stipulates its expectations towards supervised financial institutions. These expectations consist of three aspects.

First, the supervised institutions are expected to proactively engage with the guidance and recommendations issued by the BCBS and the IAIS, respectively. Adherence thereto shall ensure the alignment of Swiss institutions' practices with internationally established rules and, ultimately, a level-playing field among Swiss and foreign institutions.

Second, supervised financial institutions are expected to consider best practices in the market and to partake in market-based initiatives in the field of sustainability and climate risks. This second expectation is based upon the same motivation as the aforementioned adherence to the guidance and recommendations of the two international bodies.

Last, FINMA expects and calls upon supervised financial institutions to continuously scrutinise their approaches and tools to managing climate risk and, if necessary, to adapt and to develop them in accordance with their institution-specific risk profiles. Such a continuous evaluation will allow supervised financial institutions to better identify, assess, and manage climate risk.

Implementation of Climate Risk Management in the Supervisory Framework

Similarly to how FINMA expects supervised financial institutions to implement the recommendations of international standard-setting bodies into their (climate) risk management, it will also draw from these recommendations to develop its own supervisory framework and practices.

Indeed, FINMA already includes climate risks in its supervisory activity, all within the pre-existing legal framework. The focus of this current practice, however, lies on large financial institutions (i.e. institutions in supervisory categories 1 and 2). Going forward, FINMA intends to expand this practice to a larger number of financial institutions and to generally intensify its supervision of climate-risk management.

This qualitative and quantitative expansion will occur in line with international standards and best practices, all the while giving due consideration to the principle of proportionality – in particular, with respect to smaller financial institutions.

Conclusions and Next Steps

In its Guidance 01/2023, FINMA has underlined the crucial role of climate risks for the financial sector at large, the need for financial institutions to meaningfully manage these risks, and the importance of an adequate supervision of the climate risk management.

Furthermore, FINMA is committed to enhance and to refine the climate risk management as well as the supervision thereof in alignment with the recommendations issued by international standard-setting bodies.

While the guidance does not contain any specific measures to be taken, it signals that such steps will be taken in the future and that supervisory measures regarding climate-risk management will be expanded in both a quantitative and qualitative manner, underlining the importance of incorporating climate risk adequately into the overall risk management of financial institutions.

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