Management of climate- and other nature-related financial risks for Swiss Banks

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On 1st February 2024 FINMA released the draft for its new Circular on nature-related financial risk. This report analyzes the proposed requirements, illustrates how they tie into existing requirements for Swiss Banks around climate change, highlights key success factors and explains how KPMG can support you to ensure compliance with the new requirements.

1.1 Background

The circular specifies existing requirements on governance, risk management and the associated internal documentation pursuant to the Banking Ordinance.

It applies to all banks, financial groups or financial conglomerates pursuant to the Banking Ordinance. Exempt are particularly liquid and well-capitalized banks in categories 4 and 5 in accordance with Art. 47a–47e of the Capital Adequacy Ordinance[1]. However, FINMA recommends such institutions to consider the requirements of the Circular, should they be exposed to material nature-related financial risks.

[1] Banks of supervisory category 4 and 5 which do not meet these criteria have to comply with the requirements of the circular.

Nature-related financial risks relate to direct or indirect financial losses or other negative effects on an institution, in the short, medium and long term, resulting from its exposure to natural risks. As such, they encompass a broader scope than climate risk, such as the loss of biodiversity, air-, water- and soil pollution, water scarcity and deforestation. Nature-related risks can be seen as drivers that can be reflected in existing risk types through various transmission channels. They impact credit risks (including counterparty credit risks), market risks, liquidity risks, operational risks (including legal and compliance risks), business risks and reputational risks (including legal and compliance risks).

Generally, the requirements of this circular must be implemented by institutions depending on their size, complexity and structure as well as their risk profile and business model. As such, the materiality assessment procedure described in the Circular (see below for further details) will be a key step in determining the scope of application of the Circular.

	By 1 January 2025	By 1 January 2026		By 1 January 2027
Who	Institutions in categories 1 and 2	Institutions in categories 1 and 2	Institutions in categories 3, 4 and 5	Institutions in categories 3, 4 and 5
What	• Risk identification, materiality assessment and scenario analysis • Consideration of nature-related risk in the institutions business objectives, strategy and financial planning • Corresponding reporting to the Executive Board and the Board of Directors	• Governance • Integration of nature-related financial risk into risk management system • Stress Testing	• Risk identification, materiality assessment and scenario analysis • Consideration of nature-related risk in the institutions business objectives, strategy and financial planning • Corresponding reporting to the Executive Board and the Board of Directors	• Governance • Integration of nature-related financial risk into risk management system

1.2 Relation to other requirements

The FINMA Circular corresponds to the BCBS Principles for the effective management and supervision of climate-related financial risks (dated June 2022). As such, it provides guidance on the methodological foundations of the information that should be disclosed to external stakeholders in accordance with the Ordinance on Climate Disclosures (which covers only the topic of climate risk). In addition, both the FINMA-Circular and the Ordinance on Climate Disclosures link with the Climate and Innovation Act (CIA)., It enshrines the Swiss climate goals that serve as the basis for firms' climate transition plans and foresees[2] biannual voluntary climate compatibility analyses for financial institutions that could feed into the disclosure requirement on forward-looking, scenario-based climate compatibility analyses

[2] Consultation Draft of the Ordinance on Climate Protection and Innovation: Bundesrat eröffnet Vernehmlassung zur Klimaschutz-Verordnung (admin.ch)

Governance and Strategy

Summary of key requirements

Key requirements of the new Circular:

- The institution defines tasks, competencies and responsibilities for the identification, assessment, management and monitoring of nature-related financial risks as well as reporting across the organization, including Board of Directors, Executive Board and independent control functions.
- The members of these bodies and units must have sufficient knowledge and experience in dealing with nature-related financial risks.
- The senior management body or the Board of Directors reviews the institution's remuneration system and adjusts it where necessary to support the institution's risk strategy regarding nature-based financial risks.

Additional requirements to be considered in the same context:

- The **Climate Disclosure Ordinance** also requires disclosure of information on the impact of climate-related risk and opportunities on the institution's business, strategy and financial planning as well as the resilience of its strategy under different climate-related scenarios.
- A key aspect represents the disclosure of information on a transition plan that is in line with Swiss climate goals. The **Climate and innovation act** contains further details regarding these goals. While the general reduction targets will also apply to the Scope 1 and 2 emissions of banks, the sectoral reduction targets will be more relevant from the perspective of their investment and lending portfolios.
- Although a transition plan is not entirely aimed at reducing a firm's exposure to climate and other environmental risk, it is a matter of strategic relevance and should therefore be owned by the Board of Directors.

Success factors

- **Leverage existing governance wherever possible:** Although it tends to take more time to effectively embed within an organization, responsibilities for environmental risk (or any sustainability matter) should allocated along existing governance structures, with the sustainability function remaining a relatively small group of subject matter experts supporting the rest of the organization with specialist knowledge. More time will be required to upskill staff and revise policies and processes, but in the long run a more effective management of environmental risk will be ensured.
- **Bespoke training:** External trainings have their role to play to ensure sufficient knowledge of the management and the control functions on sustainability matters. However, to ensure function-specific knowledge that is relevant to the role of the staff, this should be complemented with internal trainings that is specific to the business nature and processes of the institution. Also, boards and senior management should be trained to properly interpret and understand the reporting they receive on environmental risk and other sustainability matters.
- **Link remuneration only to mature environmental risk and sustainability management systems:** Linking remuneration to environmental risk management or sustainability-related goals can be very effective, however, if the remuneration mechanism is ill-conceived there is a real risk of damage to the firm. Therefore, linking ESG-matters with remuneration should only be contemplated if the underlying business is subject to a robust control environment.
- **Transition plans – focus on data and client engagement:** There is no doubt that a financial institution's transition plan is a matter of strategic importance. However, to design effective and reliable measure and design robust goals, granular information needs to be available. Therefore, any transition plan should start with a long-term plan to obtain the necessary information to help the firm identify its current positioning and understand what measures will be the most effective to achieve its net zero goals.

Risk Management

Summary of key requirements

Risk identification, materiality assessment and scenario analysis

- On a periodical basis, the institution identifies nature related risks to which it may be exposed and assesses their materiality using scenario analyses.
- In conducting its risk identification and materiality assessment, institutions should consider, at a minimum:
  - Their direct exposure to nature related risks (e.g., through financed emissions) and to their dependencies on other parties which may create indirect exposure to nature related risks (e.g., their counterparties' exposure to nature-related risks).
  - Data which needs to be adequate to assess the materiality of nature-related risks, including data which may need to be sourced externally.
  - The definition of relevant quantitative indicators and thresholds, to the extent feasible and appropriate.
- The results are documented and integrated into reporting to the Executive Board and the Board of Directors.

General requirements on Risk Management

- Institutions integrate the management, monitoring and reporting of nature-related financial risks into their institution-wide risk management and internal control system.
- This includes the consideration of possible concentration risks, such as concentrations of business activities or portfolios in certain sectors, industries, or regions.
- Based on the risk strategy, institutions define suitable risk indicators, warning thresholds or limits and integrate the monitoring thereof into existing processes.
- Institutions periodically adapt their methods and sources of information
- Institutions check that their business strategy, business model and risk management comply with public statements and legal obligations. Any discrepancies between public commitments, legal obligations and internally available information are reported to the Executive Board and the senior management body.

Credit risk management

- Nature-related risks acting as drivers of credit risk are considered throughout the entire credit life cycle, from due diligence for new customers to the ongoing monitoring of their risk profiles.
- The management and control of nature-related risks as drivers of credit risk is proportional to the institution's risk exposure, size, complexity, and business model, and may include various methods to ensure that they remain within their defined risk appetite, including adjustments to lending criteria, exerting influence on customer and transaction ratings, loan restrictions and limits for exposure to certain economic sectors, companies, or geographical regions.

Market risk management

- The institution assesses whether material nature-related financial risks can influence the value of the financial instruments in its portfolios. It identifies potential losses and the effects of increased volatility and introduces effective processes for control or mitigation.
- Institutions are expected to use scenario analyses or stress tests to better assess their nature-related risks on a forward-looking basis. Sudden shocks to the values of financial instruments are considered and the dependencies between market risk factors are assessed.
- When measuring market value positions, the banks also consider how prices of hedges and their availability may change in various forward-looking scenarios, in particular in case of a disorderly transition to a nature-compatible economy.

Liquidity risk management

- The institution reviews the potential impact of natural risks on its liquidity risk profiles, regarding possible net cash outflows and the value of high-quality liquid assets (HQLA) under normal and stressed conditions.
- Any significant effects identified are integrated into the calibration of the HQLA to be held and the management of liquidity risks.

Operational risk management

- The institution ensures that the management of operational risks takes appropriate account of the impact of material nature-related financial risks, both in the risk and control assessments and in other relevant components.
- In the case material operational risk losses materialize in connection with natural risks, this is clearly stated in the internal reporting.
- Institutions that systematically collect and analyze internal loss data and relevant external events can clearly identify losses and events related to natural risks in their reporting.
- Nature-related risks impacting business continuity are integrated in business impact analyses and disaster recovery plans.

Reputational risk management

The institution identifies potential reputational risks in connection with natural risks and assesses their impact, including financial losses. In the case of material risks, the institution integrates the handling of these risks into relevant processes and controls.

Stress testing

Category 1 and 2 banks with material nature-based financial risks integrate them increasingly into their stress-testing exercises and their internal assessment of the adequacy of financial resources. Stress testing methodology for nature-related risks is expected to meet the same requirements as for the scenario analysis.

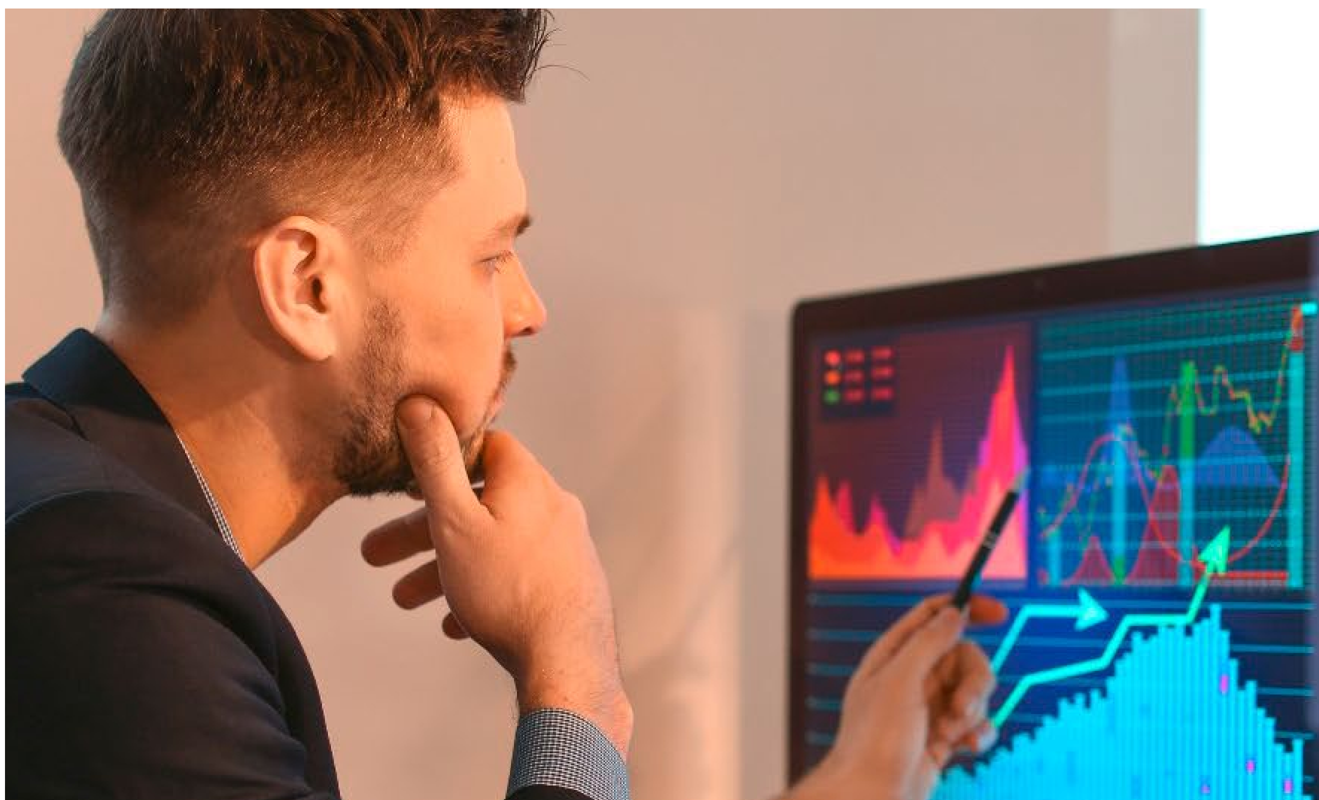
Additional requirements to be considered in the same context:

- The **Climate Disclosure Ordinance** requires disclosure on how an organization identifies, assesses and manages climate-related risks. Also, financial institutions should report on forward-looking, scenario-based climate compatibility analyses.
- The current draft of the **Climate Protection Ordinance** foresees biannual voluntary climate compatibility analyses for financial institutions. These can provide insight for financial institutions that are of relevance for the compliance with the FINMA Circular and can feed into the disclosures pursuant to the Climate Disclosure Ordinance.

Success factors

- **Focus on material parts of the book and material risk drivers:** Given the potentially vast universe of risks, it is important to focus on the most material risks. For most Swiss banks this is likely to include transition risk for corporate and SME loans as well as reputational risks. The principle of proportionality should be borne in mind. Similarly, banks should focus first on the most material gaps in their risk processes.
- **Consider impact as well as probability:** When considering the materiality of different ESG risks, it is important to go beyond exposure and event probability, and look at the financial impact of possible events. For example, mortgage defaults may increase in probability but the financial impact remains small provided the collateral value remains sufficient.
- **Use scenario analysis synergies:** Where possible the same methodologies should be used to assess materiality and incorporate nature (and especially climate) risks into capital impacts through stress testingDesign scenario analysis to be proportionate and transparent: Scenario analysis quickly becomes complex, often without significant additional insight being generated. So it is necessary to develop a pragmatic approach balancing granularity with explicability. It may be helpful to deep dive on a smaller number of material exposures. In the choice of scenarios, institutions should leverage existing published scenario data such as those produced by the IPCC, enriching them as necessary.
- **Consider business risk:** Impacts on credit spreads as well as decarbonization activities themselves can threaten revenues, so it is important not to neglect the revenue side when performing a wholistic risk review.

- **Consider upstream impacts:** If performing a deep-dive analysis on a specific corporate exposure, consider that the key physical risks may not lie with firm's own buildings but with upstream effects, such as the impact of drought on prices of agricultural produce.
- **Always run a base case:** Scenario analysis is of limited value if results cannot be compared to some kind of base case to isolate the impact of the scenario idiosyncrasies.
- **Consider location data:** It is critical to make an early assessment of data requirements. For many firms, and particularly for the corporate and SME loan book, obtaining detailed data on site locations is critical for physical risk assessments. You may need to ask you obligors directly for this data as sourcing it commercially is expensive.
- **Establish a greenwashing framework:** Institutions should identify and assess material greenwashing risks across a firm- product and client-perspective enhance their existing (reputational-) risk frameworks and implement additional controls as necessary.
- **Start with the data you already have or that is publicly available:** Even for relatively nascent sustainability risk drivers like biodiversity risk, banks will find that they do not start on a blank sheet of paper. As a first step, some banks have already conducted materiality assessments to analyze and evaluate their individual sensitivity to biodiversity risk drivers using already available internal data, supplemented by public data. ENCORE has established itself as a popular database for analyzing sectors in terms of their dependence and impact on nature. To analyze indirect risks arising from supplier relationships in addition to the direct risks from ENCORE, KPMG has developed a tool that combines the ENCORE database with EXIOBASE.



Public Disclosure

Summary of key requirements

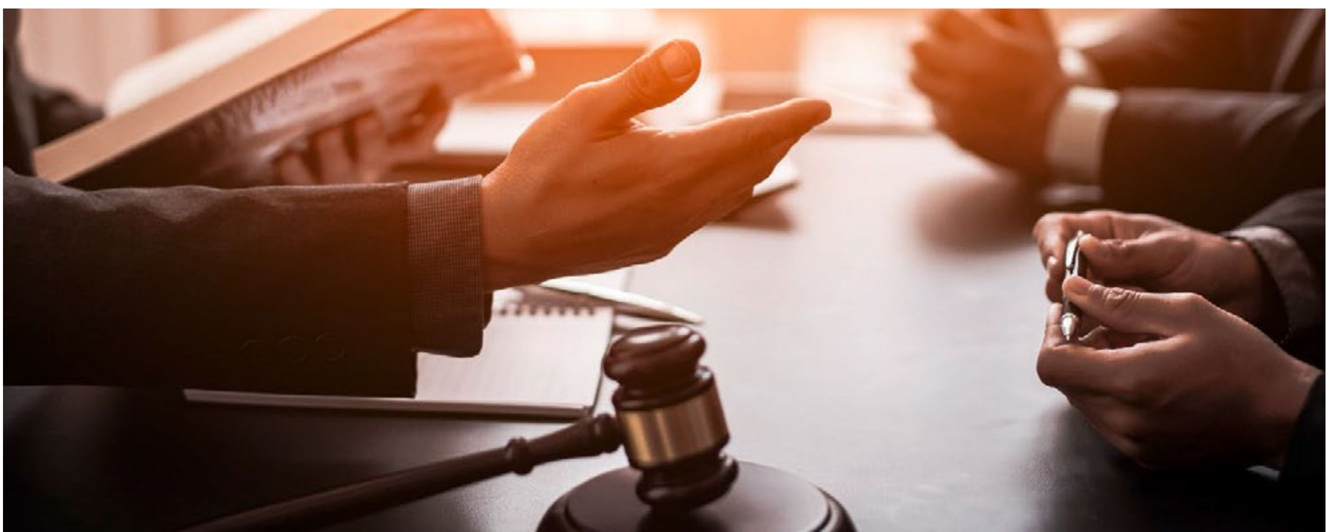
Financial institutions with 500 or more employees and at least CHF 20 million in total assets or more than CHF 40 million in turnover are obliged to report publicly on climate issues. Public reporting involves disclosures not only on the financial risk that a company incurs because of climate-related activities, but also on the impact of the company's business activities on the climate. In addition, the company must describe the reduction targets it has set for its direct and indirect greenhouse gas emissions, as well as how it plans to implement them.

Additional requirements to be considered in the same context:

Financial institutions should disclose the result of forward-looking, scenario-based climate compatibility analyses. To support the Swiss financial industry with these complex matters, the draft Climate Protection Ordinance requires the Swiss government to organize bi-annual voluntary climate compatibility analyses for financial institutions. These insights will not only help financial institution comply with their disclosure requirements but will also provide valuable data on the progress of its portfolio-level decarbonization plans.

Success factors

- **Accuracy and Transparency:** Accurate data and transparent reporting are fundamental. This involves thorough research and analysis to identify and quantify climate-related risks relevant to the organization's operations, supply chains, and stakeholders. Transparent reporting means clearly communicating methodologies, assumptions, and limitations of the data and analysis presented. This builds trust with stakeholders and ensures informed decision-making.
- **Forward-looking Approach:** Excellent climate risk reporting goes beyond historical data and considers future scenarios and projections. It involves scenario analysis to assess potential impacts of different climate scenarios on the organization's business model, financial performance, and reputation. By adopting a forward-looking approach, organizations can better anticipate and adapt to changing climate conditions and regulatory environments, enhancing resilience and sustainability.
- **Stakeholder Engagement and Communication:** Engaging with a wide range of stakeholders is crucial for effective climate risk reporting. This includes investors, customers, employees, regulators, and local communities. Actively seeking input from stakeholders helps to identify their priorities, concerns, and expectations regarding climate risks and resilience efforts. Moreover, clear and tailored communication of climate risk information ensures that stakeholders understand the potential impacts on the organization and can make informed decisions. Regular dialogue and feedback mechanisms also demonstrate the organization's commitment to transparency and accountability in addressing climate-related challenges.



1.3 How KPMG supports banks

Risk Identification

- **Exposure assessment:** Identifying key climate and nature risk drivers and sensitivities for a portfolio
- **Scenario analysis:** Assessment of an institution's vulnerability to hypothetical climate scenarios

Risk Integration

- **Risk mapping:** Identification and prioritization of ESG-related risk drivers and mapping to existing risk taxonomy
- **Greenwashing TOM:** Design effective control framework to address greenwashing risks on firm, product and service level
- **Climate transition plans:** Design firm- or portfolio level decarbonization plans across sectors and asset classes in line with best practice

Stress Testing & Scenario Analysis

- **Scenario selection** based on regulatory requirements and KPMG proprietary methodology where appropriate
- **Physical risk analysis** making of appropriate external data
- **Transition risk analysis** focusing key economic drivers
- Assessment of the **impact on capital requirements**

Disclosures

- **Gap analyses and interoperability assessment** for climate and nature reporting under various standards (TCFD, TNFD, GRI, ESRS, ISSB, etc.)
- **Reporting TOM:** Definition and implementation of robust processes and controls for non-financial reporting

Governance

- **Health Check:** Assessment of the institution's extent of ESG integration across entire business
- **ESG (Board) Trainings:** Design and deliver ESG trainings tailored to the needs to the institution
- **ESG Governance Target Operating Model:** Detailing the composition of the management bodies and overall ESG organizational structure
- **Goals ans compensation alignment:** Benchmark approach to identify and compare incentive schemes and remuneration policies linked to sustainability matters

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