Oliver Wyman

Climate and Compliance

THE TIME TO ENGAGE IS NOW!

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Climate change is a reality, and one of the most important challenges of this generation. Financial institutions are exposed through both physical and transition risks, and have an important role to play in mobilizing resources for investments in climate mitigation. In most financial institutions, Senior Management, Risk functions and some business areas are already very active in climate related efforts. However, thus far we have seen Compliance only working at the fringes of climate related initiatives and often in a tactical manner.

While Compliance usually jumps into the action once laws, rules and regulations are finalized which is not yet the case on climate, it is time for Compliance to get off the sidelines and into climate efforts. The stakes are simply too high to wait; missteps today and tomorrow will most certainly lead to regulatory, reputational and litigation costs in the future. In addition, Compliance already has many tools in its arsenal to help financial institutions achieve their climate objectives but needs to deploy them in a strategic way.

The purpose of this paper is to provide a framework for how Compliance functions can support their institutions to meet their climate objectives and minimize reputational and regulatory issues going forward.

RECAP OF CLIMATE APPROACH IN FINANCIAL INSTITUTIONS

Financial institutions are exposed to climate risk in two key areas (i.e., physical risk and transition risk):

- **Physical Risk:** Severe weather events may have a direct impact to buildings or other physical assets of the firm, its third parties, or to the communities it operates in, thereby altering its operations. Similarly, severe weather events may have a direct impact to the assets supporting the firm's loan portfolio, thereby hampering asset value and increasing the risk of default.
- **Transition Risk:** As the economy transitions to lower carbon emissions, assets may incur losses on exposure to firms with business models that are not built around low carbon strategies. These firms may experience disruption in business, incur higher cost of funding, litigation or experience lower revenues as policy changes and consumer demands shift towards a low carbon economy.

Financial institutions also have a critical role to play in the ongoing effort to slow global warming.[1] This includes educating and influencing behavior through client engagement in order to reduce emissions through higher cost of funding or reduced access to financing, developing green products that hold true to their labels, and directly reducing the carbon footprint of the bank. While there has been some financial services regulatory activity in this space globally and in the US, it is still very much a work in progress.

In light of investor and public sector engagement, many banks have been making "net zero" pledges, promising to be carbon neutral in financing activities by 2050 or earlier. At COP26, the Glasgow Financial Alliance for Net Zero (GFANZ) announced that more than 450 firms in the financial services sector across 45 countries that represent more than $130 trillion of financial assets have committed to align their activities to transitioning to net zero and to work to deliver the $100 trillion investment needed to achieve net zero over the next three decades.[2] Banks should be able to achieve net zero emission within their own operations, but it will be much harder to achieve net zero emissions in their financing activities with their clients.[3]

Furthermore, financial institutions are putting quite a bit of effort into amending their risk frameworks to consider climate considerations (e.g., integrating climate into risk measurement). While there is no clear dominant governance and accountability model with respect to climate risk, we observe that Chief Risk Officers (CRO) often have taken the lead on this in large financial institutions with a focus on climate risk scenario analysis and risk quantification. Within Risk most banks have created a Head of Climate Risk that reports to the CRO or is embedded in the Enterprise Risk Management function (ERM). We also see that most large financial institutions have appointed a Chief Sustainability Officer for climate matters who helps define and drive the program of work.

1 "Signatory Directory", Accessed October 2021, UN Principles for Responsible Investment

2 "Wells Fargo is the last of the Big Six banks to issue a net-zero climate pledge. Now comes the hard part", Eamon Barrett, March 9, 2021, Fortune

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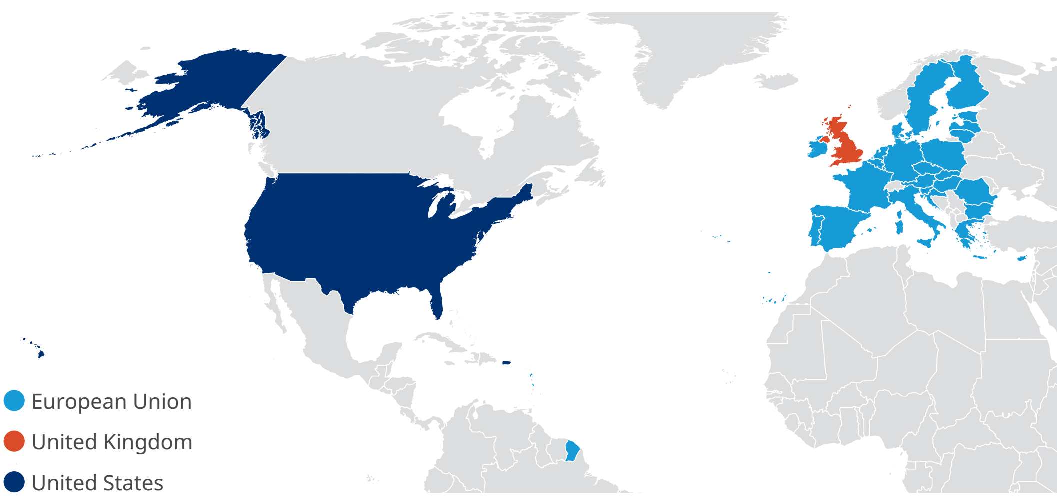
RECAP OF GLOBAL CLIMATE REGULATORY EFFORTS

The United Nation's Intergovernmental Panel on Climate Change has emphasized the need for action across public and private sectors to support the implementation of the ambitious actions required to limit global warming.[4] Governments are working to address this global issue and chart a path forward. At COP26 the Network for Greening the Financial System (NGFS) announced that 100 central banks, including the European Central Bank, Bank of England, Federal Reserve, and Bank of Canada, have now joined their network and signed the NGFS Glasgow Declaration[5], which included a continued commitment to advance supervisory practices. Additionally, the IFRS Foundation announced the formation of a new International Sustainability Standards Board (ISSB)[6], which seeks to develop a comprehensive global baseline of high quality sustainability disclosure standards to meet investors' information needs — building further upon the work of the Task Force for Climate-Related Financial Disclosures (TCFD), which will continue to be taken forwards in 2022. Approaches are more developed in Europe, the UK, and (increasingly) the US and Canada (i.e. OSFI has signaled a principles-based approach aligned with global standards while considering the Canadian context).[7]

Exhibit 1: Global Climate Regulatory Efforts at a Glance



4 "Global Warming of 1.5°C", 2019, IPCC

5 The NGFS Glasgow Declaration is available here.

6 Details on the International Sustainability Standards Board (ISSB) are available here.

7 "OSFI Summarizes Responses to Its Climate Risk Discussion Paper", 2021, OSFI

EUROPEAN REGULATION

The European Union has been at the forefront of creating sustainability focused regulation for the past few years. Their three-pronged approach includes the Green Taxonomy, the Sustainable Finance Disclosure Regulation (SFDR), and the Corporate Sustainability Reporting Directive (CSRD).[8] The Green Taxonomy serves as a foundation for the SFDR and CSRD. It has six environmental oriented objectives and looks to classify what is sustainable. First enacted in March 2021 and subject to further change, SFDR applies to financial services organizations such as asset managers, pension funds, and insurers and requires them to disclose how Environmental, Social, and Governance (ESG) factors fit into their investment decisions.[9] Adopted in April 2021, the CSRD will fully come into effect in 2023 and will apply to all "large" companies and all companies (other than micro-companies) with securities listed on EU-regulated markets (almost 50,000 companies), requiring them to report how their businesses affect the environment and their stakeholders.[10] In addition, the European Central Bank (ECB) published a Guide on climate-related and environmental risks in November 2020, which, among other things, required banks to conduct a self-assessment against the ECB's supervisory expectations and develop action plans. During 2021, the ECB has benchmarked the self-assessments and plans and in 2022 will conduct a full supervisory review.

UK REGULATION

Climate regulation in the United Kingdom has required climate metrics such as greenhouse gasses and energy usage to be reported for publicly traded companies.[11] COP26 signaled a greater emphasize, with the Bank of England announcing that it will shift gears to actively supervise firms on climate-related financial risks[12], and the UK announcing the intention to become the world's first net zero aligned financial center, with a new requirement for mandatory net zero transition plans for UK financial institutions and companies. A new task force will be established in the UK government to develop standards before the end of 2022 with the expectation that firms will be required to publish transition plans in 2023, and that this will cover both public and private firms.

US REGULATION

While the Biden administration has made climate change a priority, the impending regulation will likely be more measured. In October 2021, the Financial Stability Oversight Council (FSOC) which is the coordination body for US regulators released a report identifying climate change

8 "New EU ESG Disclosure Rules to Recast Sustainable Investment Landscape", Jennifer Laidlaw, August 3, 2021, S&P Global

9 "New EU ESG Disclosure Rules to Recast Sustainable Investment Landscape", Jennifer Laidlaw, August 3, 2021, S&P Global

10 "Proposed EU Directive on ESG Reporting Would Impact US Companies", Sander de Boer and Julie Santoro, June 7, 2021, Harvard Law

11 "ESG Regulations: What UK Organizations Must Know to Comply", Helen Hopper, August 9, 2021, Diligent

12 PRA's 2021 Climate Change Adaptation report is available here.

as an emerging and increasing threat to US financial stability requiring member agencies to, among other things, assess climate related financial risk through scenario analysis and enhance climate related disclosures. The Federal Reserve Board (FRB) has already commented on the financial risks posed by climate change and they recently announced they will conduct "scenario analyses" on banks to measure the impact of climate related risks.[13] The Securities and Exchange Commission (SEC) has also made ESG a priority and created a Climate and ESG Task Force to identify instances where companies are misrepresenting their ESG related disclosures or ESG investing strategies and misleading investors.[14] In addition SEC Chairman, Gary Gensler, commented that the Commission is considering a phased approach in mandating climate related disclosures.[15] In fact, it is clear that the SEC has already begun investigations relating to climate and ESG claims so this is already an existing compliance challenge and not just a theoretical one.[16] While all of these developments are relatively new and have only occurred within the last year, they signal a shift in the broader US regulatory landscape as the key regulators acknowledge there is financial and investment risk imposed by climate change.

13 "Fed moving forward with plans to test banks' climate risk: Brainard", Hannah Lang, October 7, 2021, American Banker

14 "SEC Announces Enforcement Task Force Focused on Climate and ESG Issues", March 4, 2021, SEC

15 "SEC Eyes Phased Approach to Climate Reporting, Gensler Says", Andrew Ramonas, October 5, 2021, Bloomberg Law

16 "ESG Asset Managers and Investment Funds — Near-Term SEC Enforcement Risk", August 3, 2021, Wilmer Hale

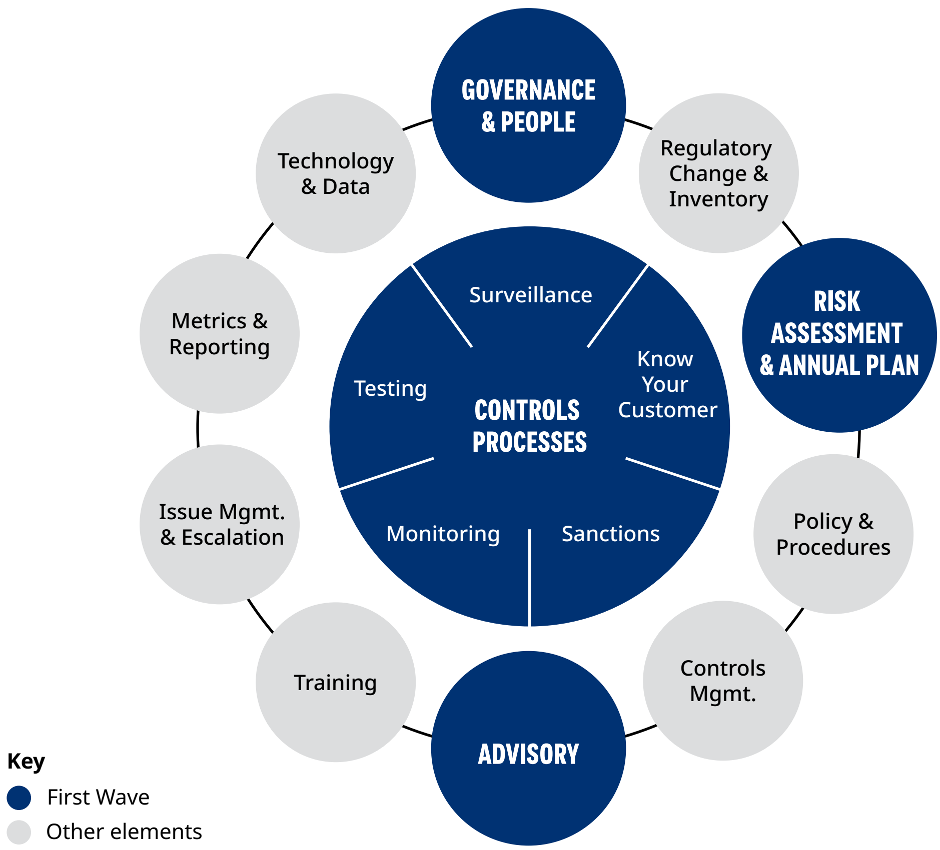
INCORPORATING CLIMATE INTO THE COMPLIANCE FRAMEWORK

We see that Chief Compliance Officers (CCO) are increasingly realizing that climate is an important area for Compliance to weigh in on, but there is a lack of clarity on what the engagement model should be as the regulatory environment continues to evolve. While the roles of other executives are becoming clear, the role of the CCO is still quite undefined as it relates to climate.

Due to the importance of the issue and the lack of clarity of the CCO role, we believe that Compliance ought to develop a top-down strategy for climate, rather than waiting for it to materialize in a bottom's up manner. This strategy should be coordinated with the CRO's so as to establish clear roles and responsibilities across the 2nd line of defense and appropriate coordination to optimize the control environment of the firm and avoid duplication. The Compliance effort should be guided by the principles of being pragmatic and specific, (i.e. not highly conceptual), avoiding duplication with other areas (e.g., Risk, Legal) and dynamic as this area is subject to quite a lot of fast paced change so, in other words, the perfect will likely be the enemy of the good in the case of climate.

The remainder of this paper will focus on the "First Wave" of actions that Compliance functions should prioritize as they seek to engage in and support their bank's climate strategy and risk management efforts. In Exhibit 2 we have outlined the OW Compliance/AFC risk management framework and highlighted these First Wave focus areas.

Exhibit 2: First wave of impact across Compliance/AFC Risk Management Framework



Source: Oliver Wyman analysis.

RISK ASSESSMENT & ANNUAL PLAN

Climate issues may bubble up in the normal Compliance risk assessment and annual planning process in distinct areas like product misrepresentation or misleading marketing materials, but this bottoms up approach will likely only lead to a tactical and incremental response. To address the importance of the issue and the amount of emerging regulatory activity, this area may require a bolt-on strategy on top of the normal risk assessment process. The strategy should consider current regulations and regulatory initiatives, and the firm's climate strategy, products and public commitments. These considerations should be evaluated in connection with the bank's existing Compliance/AFC framework to develop a dedicated First Wave action plan that can be incorporated into the overall Compliance plan. We have found that a workshop approach with the Compliance leadership team, executives leading different aspects of the firm's strategy (central and business aligned) and Risk stakeholders can be a very effective way to jump start the program. The exam questions for these sessions are what can Compliance do now and in the forseeable future to help limit regulatory and reputational risk relating to climate and what is the near term role of Compliance taking into account the roles of other stakeholders in the 1st and 2nd line.

GOVERNANCE AND PEOPLE

The maintenance of a Compliance climate program is dependent on staying plugged into what is going on at the firm as it relates to climate. The CCO or a senior deputy (i.e., MD level) will need to be directly connected to the firm's climate steerco or the equivalent body and have a seat at the table with the firm's leadership on this topic. This is appropriate since climate is already, and will undoubtedly continue to be, one of the most significant regulatory challenges facing banks. It will enable Compliance to provide appropriate challenge to the firm's strategy and public commitments. For example, Compliance could challenge whether there is sufficient granularity around the plan to support the financial institutions' "net zero" pledge and whether there is enough progress being made against that plan.

We also believe that a small group should be built to support the Compliance accountable executive to assist in the maintenance of the program (i.e. Climate Centre of Excellence). This group would be responsible for coordinating the Compliance response to climate, including the following activities:

- Collecting climate related regulatory horizon scanning information to provide a clear view on potential changes and the implications of future regulation.
- Keeping a heat map of all the climate related activities occurring in the bank which will enable Compliance to be engaged in the appropriate places where activity is occurring.
- Educating the rest of the Compliance function on climate related matters and driving the incorporation of climate into their activities/functions.
- Serving as the advisory/coverage team for the Firm climate accountable executive and the team supporting that individual(s), and the primary interface with the accountable executives in Risk and other functions (e.g., Legal).
- Keeping risk related metrics, lessons learned from issues and other trend data on the outputs of the Compliance processes to enable a better understanding of the potential regulatory risk the financial institution is running with respect to climate.

POLICY STANDARDS, ADVICE AND CHALLENGE

To date, most Compliance functions provide targeted piecemeal advisory support to the various business units developing climate related products, especially in asset management and wealth businesses. Compliance should work with the business to help drive a cohesive approach to product name designations and related disclosures so there is clear guidance and consistency across the businesses. Compliance should consider whether it is necessary to amend policies or standards to cover these issues.

It is clear that there will continue to be a bevy of new and enhanced products for all types of clients that incorporate climate related aspects. We are in the early days of the development of new and innovative products in this area. Accordingly, Compliance will need to continue to be very active in all aspects of the new business process to provide challenge and help ensure the policy standards are upheld. Compliance will need to be at the table early on as products are being developed, as well as, when they make it to the formal new business process. As the financial institution climate frameworks evolve, it will be essential to have an engaged and informed set of Compliance busines coverage teams to avoid regulatory and reputational pitfalls. As referenced above, the climate COE can help educate business coverage Compliance teams and monitor climate product developments at the firm-wide level.

As is normally the case, Compliance should not only drive policy standards and provide advice and challenge but should also use its substantial control toolset for climate.

COMPLIANCE CONTROL PROCESSES

Compliance already has quite a few existing tools that can be deployed to mitigate risk in the climate space. The climate COE will need to help define which tools/processes should be used and help upskill the employees in these groups so that they are able to meaningfully engage on this topic. It is essential that Compliance consider the full set of control processes in its arsenal to obtain the optimal level of risk management as the climate challenge develops.

Probably the most impacted area is the marketing material review function in Compliance. This area will see the marketing materials related to climate and can help ensure that they meet the policy standard referenced above and are fair and balanced. Another area that will be highly impacted is the group in Compliance that does electronic communications surveillance. The lexicons and review logic will need to be upgraded in order to capture potential misstatements or exaggerated claims regarding climate. The COE can provide assistance in developing an appropriate lexicon/tagging logic.

There may be other control processes in Compliance that should be deployed. For example, in some institutions Compliance is responsible for guideline monitoring in asset management businesses. This will be very important to ensure that climate related guidelines are honored by portfolio managers. Similarly, there may be trade surveillance for institutional businesses and “best interest” related surveillance for wealth management businesses that can be upgraded to cover climate related risks. Compliance leadership should also consider how the substantial monitoring and testing program can be utilized to support the institution’s climate strategy.

There may also be other processes that can be enhanced to help in the broader climate effort. For example, the KYC process can be utilized to obtain a better understanding of the underlying business of potential customers (e.g., subsidiaries that have a high carbon footprint). Also, watch and restricted lists could be leveraged to help the firm limit business relationships with climate unfriendly customers.

As referenced above, the COE ought to gather data on the outputs of the processes established for the “First Wave” risk management activities and support the CCOs effort to escalate emerging risks, as well as, iterate the future waves of the program as Compliance learns as it goes, and regulations change.

CONCLUSION

While regulation around climate change is ramping up, many bank leaders have made climate a top priority for their institutions and have crafted and began executing on their own climate strategies. In light of the pace of change driven from regulatory, media and societal perspectives, financial institution governance and control processes may not yet have caught up to the leadership's articulated ambition. Compliance should not wait for the regulatory process to further evolve or the governance processes to further develop to engage in the climate efforts. The Compliance group can be an essential participant as they will be able to leverage/enhance their existing processes to support the bank's climate strategy. Not only will these efforts give banks a head start on complying with new regulations, but it will allow them to more effectively manage their risk, showcase their climate competencies to their clients and do their part to address the climate challenges ahead.

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

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