Appearance at the Senate BANC Committee
Bill S-243
December 6, 2023

On December 6, 2023, Superintendent Peter Routledge and Managing Director of the Climate Risk Hub, Stephane Tardif, will appear before the Senate Standing Committee on Banking, Commerce, and the Economy as they study Bill S-243. The following are a list of questions that both witnesses could be asked by senators during their testimony at committee.

Table of Contents

Appearance at the Senate BANC Committee Bill S-243 December 6, 2023 1

Key Messages 2

- If asked about S-243 proposed amendments the OSFI Act 2
- If asked about aligning supervision regulations with climate commitments 2
- CESD report 3
- OSFI's future work in the climate space / Could OSFI do more? : 3
- How does OSFI view climate related risks? 3
- OSFI's work preparing financial institutions to manage climate related risks 4

OSFI – Current Approach to Climate Risk Management 4

- OSFI's mandate – is it suitable to tackle climate risks in Canada's financial system? 4
- Climate-related financial risks in OSFI's updated supervisory framework 4
- How exposed are financial institutions to climate risks? 4
- Ensuring consistency across federally regulated pension plans and FRFIs, in terms of data, disclosures, vulnerability analyses, and regulatory and supervisory practices 5
- Does the Guideline incentivize lenders to offload high GHG exposures to private equity vehicles with no transparency? 5
- There is a link between climate change and national security. How will OSFI's approach to climate risks change in accordance with its expanded mandate per Bill C-47. 6

Capital 6

Disclosure and Data 8

Greenwashing 9

Net Zero Alliances 10

Transition Plans 10

Scenario Analysis 12

Taxonomy 12

Key messages

- OSFI's mandate (*in accordance with the legislative framework set out by Parliament*) empowers us to act to ensure federally regulated institutions are managing the risks that climate change may pose to their safety and soundness.

- We know that Canada's financial system will be a critical enabler in the adjustment to a low carbon economy and OSFI has an obligation to ensure that FRFIs and federally regulated pension plans (FRPPs) are fit to manage the risks that will accompany that adjustment.

- OSFI believes our approach to Climate Risk Management balances concerns of stakeholders in all regions of Canada

- We recognize that climate change and the global response to the threats it poses have the potential to significantly impact the safety and soundness of the Canadian financial system.

- This year, OSFI:
    - finalized its Guideline B-15: *Climate Risk Management* which sets out OSFI's foundational expectations for federally regulated financial institutions.
    - inaugurated our Climate Risk Forum to fulfill the recommendations around transparency made by the Commissioner.
    - Issued draft versions of our Climate Risk Returns for Federally Regulated Financial Institutions and our Standardized Climate Scenario Exercise (SCSE) methodology.

- OSFI recently tabled its Departmental Sustainable Development Strategy that is aligned with the 2022 to 2026 Federal Sustainable Development Strategy and contributes to the United Nations' Sustainable Development Goals.

- By 2024 OSFI will have updated its Supervisory Framework to integrate climate-related risks. The amended Supervisory Framework and Guideline B-15's expectations will be applied to supervisory assessments and risk ratings for large financial institutions in 2025, and to all other institutions in 2026.

If asked about S-243 proposed amendments the OSFI Act

- OSFI's mandate under the current legislation is clear and we feel that, as it stands now, it provides us with effective and powerful tools to manage the risks associated with climate change facing Canada's financial system.

If asked about aligning supervision regulations with climate commitments

- OSFI understands that climate-related physical risks and transition risks have the potential to increase the probability of system-wide and institution-specific financial stress.

- OSFI's supervision and regulation of financial institutions is based on a regulatory framework that is designed to control and manage prudential risk.

CESD report

- OSFI agrees with the five recommendations in the CESD report on supervision of climate-related financial risks and is taking concrete steps to address them.

OSFI's future work in the climate space / Could OSFI do more?

- We are proud to be among a very small group of regulators around the world who have issued prudential guidance on climate, including mandatory disclosures, and are incorporating climate related risks in assessments of financial institutions. We are the only financial regulator in North America to do so.

  Guideline B-15

  - We will supervise climate-related risk management in accordance with the principles-based regulatory expectations as published in Guideline B-15: Climate Risk Management.

  - These expectations will be integrated with OSFI's new Supervisory Framework.

  Climate Risk Forum

  - OSFI's Climate Risk Forum, launched earlier this year, will raise awareness, and build capacity amongst stakeholders on the evolution of our climate risk management framework.

  - The Climate Risk Forum will leverage industry information sessions, roundtables, and workstreams to help accelerate FRFIs' readiness to manage climate-related financial risks, further strengthening public confidence in Canada's financial system.

  Regulatory return

  - OSFI worked closely with the Bank of Canada and CDIC to develop a regulatory return to collect climate-related risk data from FRFIs. This will be mandatory for financial institutions effective fiscal year-end 2024 and will evolve as climate data matures.

    - A regulatory return is a series of questions to obtain an up-to-date understanding on the nature, size and complexity of operations to assist in determining risk.

  Scenario analysis exercise

  - We are developing a standardized climate scenario analysis exercise that all FRFIs will undertake in 2024, that will include transition risk scenarios and physical risk scenarios including floods and wildfires.

How does OSFI view climate related risks?

- We agree with financial standard setters and prudential regulators and supervisors around the world that climate-related risks have the potential to pose significant challenges for financial stability, and that we have a role to consider these risks within our mandate.

- Our own work with the Bank of Canada, and the 2022 Pilot scenario analysis exercise report, demonstrated that delayed climate policy action increases the overall economic impacts and the risks to financial stability of a sudden repricing of assets.

OSFI's work preparing financial institutions to manage climate related risks

- Canada's financial system will be a critical enabler to the adjustment to a low carbon economy and OSFI has an obligation to ensure that FRFIs and federally regulated pension plans (FRPPs) are fit to manage the risks that will accompany that adjustment.

- We are proud to be among a very small group of financial regulators around the world who have issued prudential guidance on climate, including mandatory disclosures, and incorporating climate related risks in assessments of financial institutions.

OSFI – Current Approach to Climate Risk Management

OSFI's mandate – is it suitable to tackle climate risks in Canada's financial system?

- Yes, we believe it is. Under our mandate, we've already made significant strides. We finalized Guideline B-15, launched our Climate Risk Forum, and issued draft versions of our Climate Risk Returns for FRFIs and our Standardized Climate Scenario Exercise (SCSE) methodology

- We recognize that in relation to climate-related risks, a resilient financial system will be better able to support broader economy transition and can even be a critical enabler to that adjustment.

- Climate-related risk is a very important public policy issue, but we also realize that our role is to regulate and supervise the institutions we're legislated to focus on.

Climate-related financial risks in OSFI's updated supervisory framework

- Climate risks will feature prominently in the new supervisory framework as a transverse risk. Supervisors will assess how climate change is impacting all traditional risk categories, such as credit, market, operational, liquidity.

- OSFI will clarify how climate-related risks will be addressed in the new supervisory framework for federally regulated financial institutions and pension plans, which will become effective in April 2024.

- We will publish more information about the new framework in early 2024. We held webinars for regulated financial institutions in November 2023 and will do so for pension plan stakeholders in spring 2024.

How exposed are financial institutions to climate risks?

- We have a good sense of the direct transition risk exposures in terms of credit, market, and liquidity risk. We estimate that climate relevant exposures are approximately 5% of assets for banks, 19% for Life insurance companies, and 15% for pension funds.

- What is less well understood is the indirect, or systemic, transition shocks across a small interconnected financial system like Canada, from cross holding positions, common exposures, and fire sales.
- On the physical risk front, if we look only at floods for example, Public Safety Canada estimates current damages to residential structures from flooding averages about $2 billion per year.
    - We just completed a flood study with the Bank of Canada assessing residential mortgage exposures to floods and estimate that $940 million of the average annual expected flood related loss in Canada affected properties with collateralized loan products.
    - What's more, properties located in flood zones experience on average four times larger damages, as a percent of collateral.
- OSFI is conducting a mandatory climate scenario analysis exercise for both transition risks and physical risks, including flood and wildfire, for all FRFIS in 2024, and the results will further inform our work.

Ensuring consistency across federally regulated pension plans and FRFIs, in terms of data, disclosures, vulnerability analyses, and regulatory and supervisory practices

- We strive to be as consistent as possible in addressing climate-related risks across regulated financial institutions and pension plans, while necessarily reflecting and respecting the differences between the statutory frameworks for federally regulated private pension plans and FRFIs.
- This is particularly important given that most assets under administration for pension plans are not under the supervision of OSFI. (FRPP is about 10%)
- OSFI's approach to executing its mandate, including for climate-related risks, must consider the unique application of pension plan administrators' legislated and common law fiduciary duties.
- Pension plans are private contracts and workplace benefit arrangements, and not public stand-alone businesses or corporate entities. As such, the legal framework for their supervision is different from that of financial institutions.

Does the Guideline incentivize lenders to offload high GHG exposures to private equity vehicles with no transparency?

- The risk that increasing standards for regulated institutions may shift more business to unregulated channels is always present and it's not unique to climate-related risk. This is a balance that all regulators must grapple with. That said, it cannot be a reason not to act, or for OSFI to refrain from doing its job to fulfill its mandate.
- The risk of not providing guidance to our FRFIs poses greater threat, considering the evolving landscape of climate change and its potential impact on the safety and soundness of FRFIs, and by extension, the stability of the broader financial system.

There is a link between climate change and national security. How will OSFI's approach to climate risks change in accordance with its expanded mandate per Bill C-47.

- Our expanded mandate makes us responsible for supervising FRFIs in the face of climate change and the risks from climate change in two ways:
    - To determine whether FRFIs are in sound financial condition in the face of climate-related risks.
    - To supervise FRFIs to determine if they have adequate policies and procedures to protect themselves against threats to their integrity or security, including foreign interference, including risks that could arise from climate change.
- We have a responsibility to execute on all parts of our mandate. In executing on our mandate, we must be prudent in the regulatory and supervisory tools we use to ensure that they are fit for purpose.

Capital

How are assets exposed to transition risks, such as loans and bonds to fossil fuel activities currently captured in capital requirements?

- Regulatory capital requirements for credit risk are calibrated conservatively based on past credit performance with full credit cycles. It is a consensus that a transition to a low carbon economy will happen in the future and transition risk is not likely to be reflected in past credit performance.
- The majority view on the extent to which external credit ratings would reflect such future transition events is that external credit ratings which consider the credit conditions typically for the next 3-5 years are not likely to reflect uncertain long-term transition risk.

Does OSFI's current Domestic Stability Buffer capture climate risks?

Note: S-243 would require a systemic climate risk contribution surcharge added to the capital requirements to bolster the resilience of FIs in the face of systemic risks being contributed to through financially facilitating emissions-intensive activities.

- The DSB level is set by OSFI every June and December and applies to Canada's six largest systematically important banks to account for potential vulnerabilities.
- The current DSB level reflects current vulnerabilities, including high household and corporate debt levels, the rising cost of debt, and increasing global uncertainty around fiscal and monetary policy. These vulnerabilities are cyclical in nature and relatively well understood.
- Given that climate risk is not cyclical, and its timing and impact are highly uncertain, it is fair to say that the current DSB level may not reflect the uncertainty of future climate risk.

Why does Guideline B-15 not include higher risk factors and capital requirements for fossil-fuel lending and investments?

- There are three main reasons for this:
  - The time horizon in regulatory capital frameworks is the next 1-year while climate risks are likely to materialize in the mid- to long-term.
  - The lack of empirical data and attribution methodology is the biggest challenge for the evidence- and risk-based regulatory capital frameworks.
  - The fact that a Canadian taxonomy is not yet available poses an additional challenge to define appropriate asset classes (e.g., green and brown assets) for risk differentiation purposes.

Overview of expectations with regard to "sufficient capital and liquidity buffers"?

- OSFI assesses capital adequacy at two levels. An institution must have sufficient capital to meet its target regulatory requirements (regulatory capital), as well as sufficient capital to support its risk profile (economic capital).
- Recognizing that a FRFI's climate-related risk varies with the FRFI's unique circumstances, we expect that FRFIs will continue to evaluate and measure their available capital to protect against material risks, including climate-related risks, and reflect their assessments in the banks' ICAAP or the insurers' ORSA (economic capital), as well as the adequacy of liquidity to protect against FRFI-specific and market-wide severe, yet plausible, climate-related stress events.

Would OSFI seek to penalize the "brown" assets and reward "green" assets?

- No. OSFI's regulatory capital treatment is neutral to the color (brown or green) of assets, but is sensitive to the risk level of assets, regardless of the color.
- B-15 is not designed to dis-incentivize certain assets, investments or loans in favour of others. It's meant to incentivize good risk management practices. The B-15 guideline expects FRFIs to use climate scenario analysis to assess the impact of climate-related risks on their risk profile, business strategy and business model rather than to dis-incentivize specific type of assets.
- OSFI's Regulatory Capital framework is designed to adequately absorb potential losses and provide financial stability. Capital risk weights should reflect financial risks attributed to particular assets.

What is OSFI's plan for pillar 2 climate-related capital requirements?

- OSFI's thinking on capital treatment to reflect climate-related risks and opportunities is continuing to evolve. In B-15, reflecting climate risks in the ICAAP and ORSA is the first step to identifying and quantifying these risks.
- Regulatory capital is mostly determined *ex post* or based on historic data. But given what we know about climate change and given what we know about how different assets may perform in the

future, we have to ascertain whether our approach to climate and capital is still current and sensible.

Disclosure and Data

Dependency of FIs on climate data from customers to meet climate disclosures. Is that data available?

- FRFIs rely on obtaining and analyzing decision-useful climate-related data from their counterparties, which is a key input into their climate disclosures.
    - For example, information on clients' mitigation, adaptation and transition plans will help financial institutions assess potential transition risks and informs forward-looking analysis.
- Guideline B-15 requires institutions to provide mandatory climate disclosures. Institutions are actively engaging with clients to acquire climate-related data, using questionnaires during renewal discussions, sending out surveys, or through information requests.
- Where data is limited or unavailable, FRFIs can use proxies/estimates to address the gap, however it is understood that proxies provide lower quality data. We expect data quality to improve over time.
- In addition to Guideline B-15, OSFI developed a new regulatory return designed to collect climate-related data directly from FRFIs. FRFIs could leverage the regulatory return to enhance their own data collection from their counterparties.

Does Guideline B-15 align with ISSB disclosure standards?

- We have calibrated our measurement expectations so that they remain in line with global standard setters. Final B-15 aligns with TCFD recommendations with placeholders for International Sustainability Standards Board-related expectations.

Now that the ISSB has finalized its standard we are looking to update Chapter 2, including the annexes. OSFI stakeholders will be notified of potential changes in due course.

While large institutions have the resources to tackle these initiatives, smaller companies may have more difficulty. Will OSFI apply these guidelines differently based on size?

- We appreciate the data challenges faced by smaller companies, like SMSBs, regarding calculation and disclosure of Scope 3 GHG emissions. Guideline B-15 is phased in over several years based on the size and complexity of institutions. Smaller institutions are provided more time to comply.

Will Canadian financial institutions be disadvantaged by disclosing climate risks when Wall Street banks do not have to?

- We see it differently. Having a safe and sound financial system leads to competitive advantages. Guideline B-15 expects FRFIs to demonstrate and disclose their sound climate risk management practices.

- Canadian Financial institutions will be at a competitive advantage by demonstrating that their strategies are resilient to transition and physical risks, and that they have contemplated the risks and opportunities of the transition to a lower-carbon emission real economy

How do expectations proposed in S-243 for Climate Commitment Alignment Reporting compare to those of Guideline B-15?

- The requirements of the climate commitments alignment report as listed in Bill S-243 are highly prescriptive, particularly around the climate-related targets to which it commits entities (UNFCC, Paris Agreement and amendments, and Canadian Net-Zero Emissions Accountability Act).

- Conversely, OSFI's Guideline B-15: Climate Risk Management is more principles-based and keeps a prudential perspective to understand, measure, manage and disclose their climate-related risks.

- We feel this is the best approach because climate risks impact institutions differently, based on size, complexity and business models. We believe institutions can be more effective when they can adapt their approach to reporting.

Greenwashing

What is OSFI doing to ensure financial institutions are not greenwashing?

- We believe prudent risk management can strengthen financial institutions' credibility when communicating their climate-related exposures and responses. OSFI contributes to other financial sector authorities' efforts to minimize/avoid greenwashing, in a manner consistent with our mandate.

- Greenwashing, such as marketing or making false or misleading claims on the positive environmental impact of its products, services, or operations, falls under the scope of market conduct, and is outside OSFI's prudential mandate.

Who is responsible for supervising greenwashing in Canada?

- There are a number of organizations that contribute to reducing greenwashing:

    - The Competition Bureau enforces the *Competition Act*, which prohibits companies from making materially false or misleading representations to promote any product or business interest

    - The Canadian Securities Administrators regulate market conduct.

    - The Sustainable Finance Action Council (SFAC) is helping lead the Canadian financial sector toward integrating sustainable financial into standard industry practice.

    - The ISSB / CSSB - harmonizing sustainability reporting standards can help set a global baseline to enhance transparency and comparability.

Given OSFI's mandate, when greenwashing situations arise, will OSFI work with the Competition Bureau to address such complaints?

- No. OSFI is prevented by law from disclosing information on the affairs of the financial institutions we regulate.

Net Zero Alliances

Will OSFI hold banks accountable for their net zero/climate pledges now that B-15 is final?

- No. Climate pledges and net zero commitments are voluntary by nature. OSFI does not regulate FRFI's voluntary net-zero commitments. We will supervise financial institutions against the expectations in guideline B-15, related to the management and disclosures of climate related risks, not against net zero or other climate pledges.

What can OSFI do if Banks do not meet their global alliance public net zero commitments?

- OSFI does not regulate FRFI's voluntary net-zero commitments. We focus on is B-15; prudential expectations around disclosures and risk management.

Transition Plans

While B-15 has an expectation around transition plans, it does not require alignment with Canada's climate commitments which reduces their value to bring about change.

- Our expectations around Climate Transition Plans do not account for the Government of Canada's commitments to UNFCC and Paris Agreement (N.B. "Climate Commitments" as defined in Bill S-243), as our authority does not extend to Canada's climate change objectives.

- Our focus is on financial institution resilience against risks associated with climate change – including physical and transition risks. One of our key concerns is financial institutions' mispricing of climate-related risks.

- This is why B-15 includes an expectation to develop, implement, and disclose Climate Transition Plans. The transition planning process drives financial institutions to explicitly consider how climate-related risks could impact their safety and soundness and how they would steer their business model and strategy to mitigate these impacts.

Will OSFI set clearer guidance about the information reported in the institutions' transition plans?

- OSFI expects that transition planning will increasingly become important to regulated institutions identifying, managing, and mitigating climate-related risks.

- B-15 will be iterative to harmonize with other key standards and to account for future developments in data quality and availability, and methodologies. OSFI's guidance on transition plans will evolve as needed.

Why do the disclosure requirements in Guideline B-15 not specify an effective date for the disclosures of transition plans? It is currently identified as TBD

- OSFI deliberately left the implementation date as “TBD” as we recognize that FRFIs require time to build capacity.

- As part of future iterations of Guideline B-15, and as FRFIs’ climate transition plans mature, OSFI will set the effective date for disclosure of climate transition plans.

Directors - S-243 recommends restrictions on FI board members based on climate criteria. Does OSFI have similar restrictions on board membership for other criteria?

- The quality of FRFI corporate governance practices is an important factor in maintaining the confidence of depositors and policyholders, as well as overall market confidence.

- The role of directors is defined per the *Bank Act*, the *Trust and Loan Companies Act*, the *Insurance Companies Act*. OSFI’s *Corporate Governance Guideline* (CGG) complements the relevant provisions in these Acts.

- Managing the risks associated with climate change fits within the role of directors, as it relates to their fiduciary duty to act in the best interest of the institution.

- Board composition and independence are part of OSFI’s CGG expectations as they are important elements to Board effectiveness.

    - The CGG includes expectations around Board member independence from the FRFI, but does not set out specific expectations around affiliation with any particular sector (e.g., high or low carbon sectors)

    - The requirements in S-243 would exceed OSFI’s authority.

Does OSFI have data on the percentage of FRFI Board members or Senior staff who received training or orientation related to climate risks?

- As noted in our *Corporate Governance Guideline*, we expect a FRFI’s Board of Directors (Board) to be diverse and, collectively, bring a balance of expertise, skills, experience, competencies, and perspectives, taking into consideration the FRFI's strategy, risk profile, culture and overall operations.

- As part of the release of B-15, we conducted a mandatory readiness self-assessment questionnaire (SAQ) with FRFIs to understand their approach to meeting the expectations of the guideline, including their approach to ensuring the Board, as well as employees with accountability for climate risk management, have the appropriate balance of expertise and experience to execute their respective roles and responsibilities.

    - We are analyzing the results. At a high level, FRFIs report that they recognize the importance of Board expertise and competency on climate-related risks and are taking steps to address it.

Scenario Analysis

Why is OSFI working on climate scenario analysis and mandating financial institutions to conduct these exercises in B-15?

Note: Senator Galvez was critical of climate scenario analysis in her white paper, calling the process ineffectual, limited, ill equipped and ultimately flawed.

- We disagree with that assessment of climate scenario assessment.

- Scenario analysis should not be confused with prediction. It is meant to inspire discussion among decision-makers about potential futures for their organization and to help them assess the financial, strategic, and operational ramifications of a changing climate. We believe that in doing so, financial institutions will be better prepared for the future.

- We believe that climate scenario analysis supports financial institutions in forward-looking projections of risk outcomes. It provides a framework to assess the impacts of different physical and transition risk scenarios to their counterparty and/or sector sensitivities to those risks and extrapolate the impacts of those sensitivities to their strategic planning and business model decisions.

What is OSFI doing on climate scenario analysis and stress testing financial institutions for climate change?

- We started on this journey with the joint scenario pilot exercise with the Bank of Canada and that analysis was published in January 2022.

- We have since partnered on two additional scenario exercises, one on transition risks looking at the interconnectedness of exposures across different types of financial institutions, and a detail flood analysis on bank's residential mortgage properties.

- In 2024 we will be conducting a mandatory climate scenario analysis exercise for all FRFIs for both transition risks, and physical risks, including floods and wildfires. This will be a very comprehensive structured test, and will provide valuable insights and comparable results.

Taxonomy

Are you supportive of a Canadian taxonomy?

- Establishing a Canadian taxonomy is not within OSFI's mandate. but we feel that anything that helps provide clarity to market/investors with transparency about investments and loans and their alignment with national transition pathways and climate mitigation objectives, collectively helps advance climate related financial risk management.