2022
Best Practices of Climate Risk Management Leaders

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Contents

Introduction

In 2021, the GARP Risk Institute (GRI) completed its third annual global survey of financial institutions' climate risk management practices. The voluntary survey was structured to capture six key dimensions of firms' climate risk management: governance; strategy for dealing with actual and potential climate risks; approach to risk management; the metrics, targets and limits used to assess and manage climate risks and opportunities; the use of scenario analysis to understand the risks; and climate risk disclosures.

IN THIS PAPER, WE HIGHLIGHT THE BEST PRACTICES IMPLEMENTED BY CLIMATE RISK MANAGEMENT LEADERS AND OUTLINE THE STEPS OTHERS CAN TAKE TO JOIN THEM.

Seventy-eight firms responded to the 2021 survey: 47 banks or building societies (referred to as 'banks' throughout for simplicity); 20 asset managers; and 11 other firms (insurers, financial market infrastructure). With operations in all regions of the world, these firms represent a considerable portion of the global market, with USD 46 trillion of balance sheet assets and close to USD 36 trillion of assets under management. The full survey examined the distribution of climate risk management maturity levels of all the participating firms. After being scored up to a maximum of 100 for each of the dimensions, the firms were ranked by their total score.

In this analysis, we examine how the best scoring firms compare with the others, focusing on two key questions: (1) What differentiates practices at these "leading" firms relative to the others, and how has this changed since 2020? (2) Are there broader lessons from these practices on how to progress climate risk management practices?

For the purposes of this analysis, we refer to those that scored in the top 25% of all respondents as the financial industry's "climate risk leaders"; those in the bottom 75% are simply referred to as the "other firms". A similar analysis, based on the 2020 survey, was published last year.

Key Takeaways

Let's now briefly review our most important findings:

- The firms that we classify as climate risk "leaders" are more advanced in all six dimensions covered by our survey — but the gap between the leaders and the others is substantially wider in the quantitative areas, including metrics, targets, and limits; scenario analysis; and disclosures.
- Unsurprisingly, the leaders have almost all taken a so-called "strategic" or advanced approach to climate-related risk, whereas just under half of the other firms have.
- Leaders are more likely to consider multiple types of climate risk — physical and/or transition risk — as well as portfolio alignment. In contrast, the other firms are more likely to prioritize only one type of risk, if any.
- A much large proportion of the leaders have established metrics, targets or limits to manage their balance sheet risks, relative to the other firms.
- Leaders are much more likely than the other firms to assess whether their counterparties or companies they invest in will help them meet portfolio temperature alignment or net-zero objectives.
- The leading firms are significantly more advanced in their use of scenario analysis. All leaders have used it to understand the impact of climate-related risk on their organization's portfolio or balance sheet, compared with around 60% of the others. Moreover, leaders are also far more likely to have taken action on the back of the analysis.

THE GAP BETWEEN THE LEADERS AND THE OTHERS IS SUBSTANTIALLY WIDER IN THE QUANTITATIVE AREAS, INCLUDING SCENARIO ANALYSIS, DISCLOSURES, AND METRICS, TARGETS, AND LIMITS.

Leading Firms: Most Advanced Areas

Before diving into the specifics of how leading firms differentiate themselves, Figure 1 sets out the differences between the average scores of the leading and other firms, across the six dimensions of the survey. There are some areas where there is not a major difference between the performance of the leading firms relative to the others. We call these the "Foundations," and they comprise governance, strategy, and risk management, as they did last year.

Figure 1: Average Climate Risk Score per Dimension

While climate risk leaders score better on average than the other firms in each dimension (the green bars are taller than the black/grey ones in Figure 1), the differences are much larger in some dimensions than in others. We refer to the dimensions with the more significant gap as the "Next Steps". These continue to be the more quantitative areas of metrics, targets and limits; scenario analysis; and disclosures.

The largest improvements in the scores of all firms between the 2020 and 2021 surveys were in strategy, scenario analysis, and disclosure. The leading firms' scores increased by about 10% for each of these dimensions, and the scores of non-leading firms increased by 23%, 9%, and 7% respectively.

Other firms have also progressed on governance, slightly closing the gap with the leaders. In part, the narrowing of the gaps reflects the fact that the leaders are reaching the highest scores for some of these categories — and therefore have less headroom for improvement.

The Foundations: Governance, Strategy and Risk Management

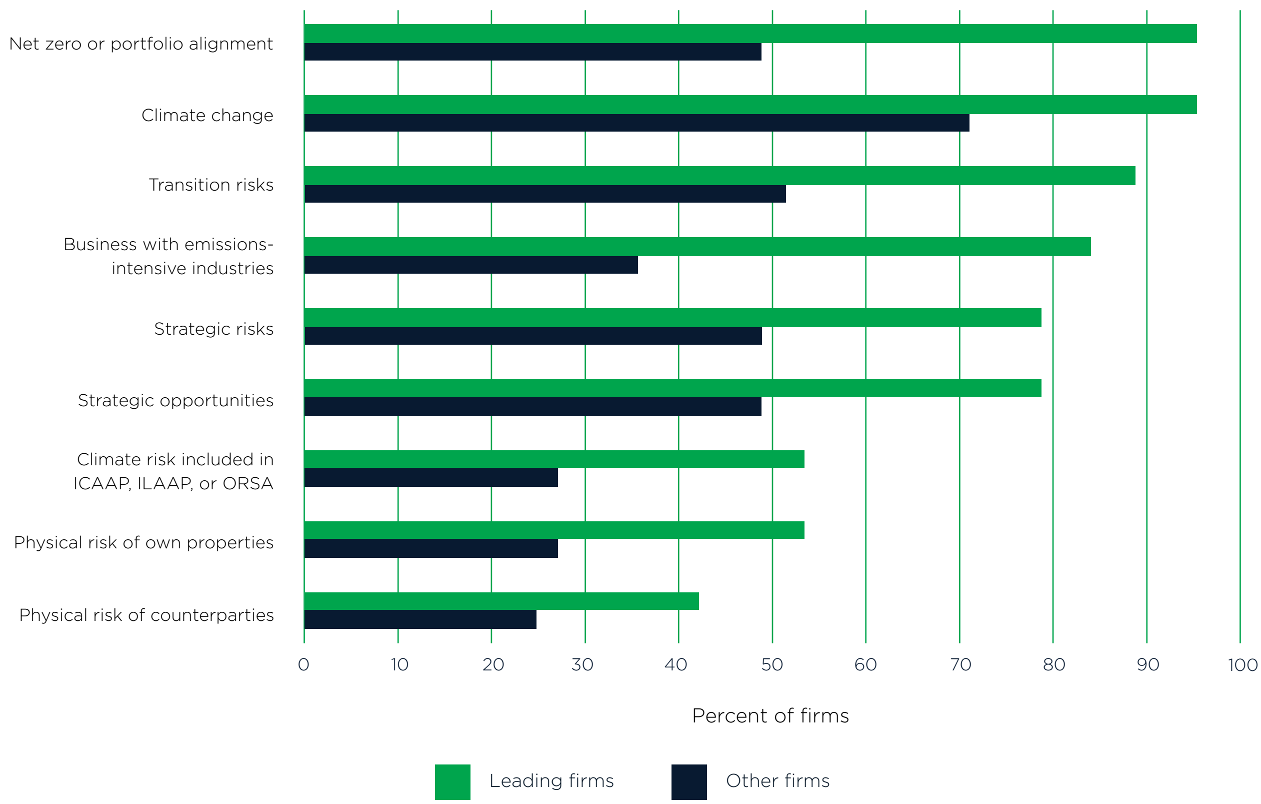
This section digs a little deeper into the three foundational elements.

Governance

Climate risk governance, like all risk governance, starts at the top of an organization. We find that nearly all firms have board-level governance: 100% of leading firms and 90% of other firms have board oversight of climate-related risks and opportunities. But they differ in the frequency of engagement and range of topics covered.

The majority (74%) of leading firms' boards have seen climate-related papers at least four times a year; this frequency is matched by only 46% of boards at the other firms.

Figure 2: Topics Discussed by Boards



Most of the leading firms' boards have seen papers covering the following: net zero or portfolio alignment; climate change; transition risks; their firm's approach to financing, insuring, or investing in emissions intensive sectors; and their strategic risks and opportunities. Less commonly seen are papers on physical risk assessments (for their own operations and for counterparties or firms that are invested in) and on climate risk integration with ICAAP, ILAAP, or ORSA; however, the boards at leading firms are still twice as likely to see papers on such topics.

All leading firms have C-level accountability for climate-related risks, whereas 12% of the other firms delegate it further down the organization, suggesting a lower level of prioritization.

Strategy

Effective risk management requires a firm to be clear on its strategy. But firms differ in their levels of ambition.

Unsurprisingly, the leaders have almost all taken a comprehensive or "strategic" approach to climate-related risk, whereas just under half of the other firms have (see box below). This is reflected in their assessment of climate risk.

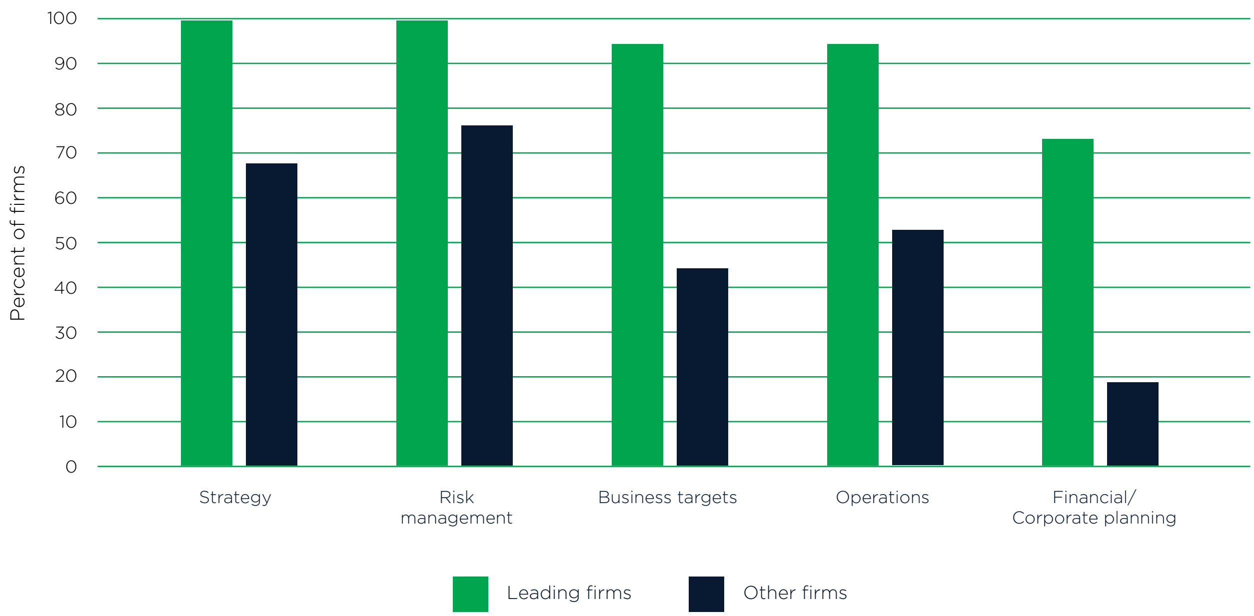
> Using terminology borrowed from the Bank of England, we asked firms to specify whether their approach to climate risk management was "responsible," "responsive," or "strategic," with each category corresponding to different levels of maturity.
>
> - **Responsible** is an approach driven primarily by corporate social responsibility (CSR), focusing on reputational risks.
> - **Responsive** means that climate change is viewed as a financial risk, albeit from a relatively narrow, short-term perspective.
> - **Strategic** implies a more comprehensive approach, taking a long-term view of the financial risks, with board engagement.

Whilst the majority of firms have identified climate-related risks or opportunities (100% of leaders, 88% of others), the leaders are more likely to look at them over longer time periods. The leaders are also more likely to think that risks and opportunities will be significant over all time periods.

What's more, leading firms are also more optimistic that their strategy is resilient to climate-related risks over all time horizons. This might be because they are also more likely to have assessed the impacts on different aspects of their business.

As Figure 3 shows, all leaders have assessed the impact on strategy and risk management, and the majority have assessed it for business targets, operations, and financial/corporate planning. Compared with last year, a greater proportion of the leaders have assessed the impact on all aspects, with nearly double the percent assessing the financial/corporate planning impacts.

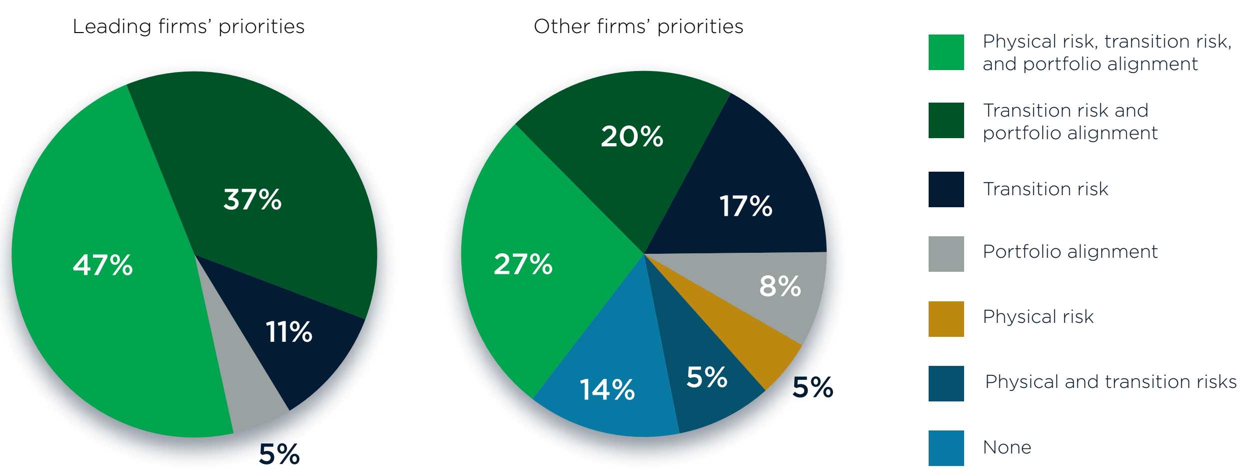
Figure 3: Business Aspects Assessed for Climate-Related Risks and Opportunities



Leading firms are also more likely to have developed different types of new products and services, from energy efficient financing to green bonds and insurance products that encourage lower emissions.

When asked which types of climate risk their firms prioritize (physical, transition, or portfolio alignment), the leading firms tend to select multiple ones, with nearly half giving physical risk, transition risk, and portfolio alignment equal priority. The other firms, in contrast, are more likely to prioritize only one type of risk, if any, as shown in Figure 4.

Figure 4: Climate Risk Priorities Across Firms



Risk Management

Leading firms are more advanced in the way that they undertake due diligence of counterparties. It is likely that a key reason that leaders are more advanced in their climate risk management is because of more intense regulatory scrutiny. All leading firms' regulators have published formal expectations for climate risk, compared with around 70% of the other firms' regulators. Moreover, leaders are nearly twice as likely to be participating in a regulatory climate risk stress test or be subject to one in which the regulator calculates the climate-related impacts themselves.

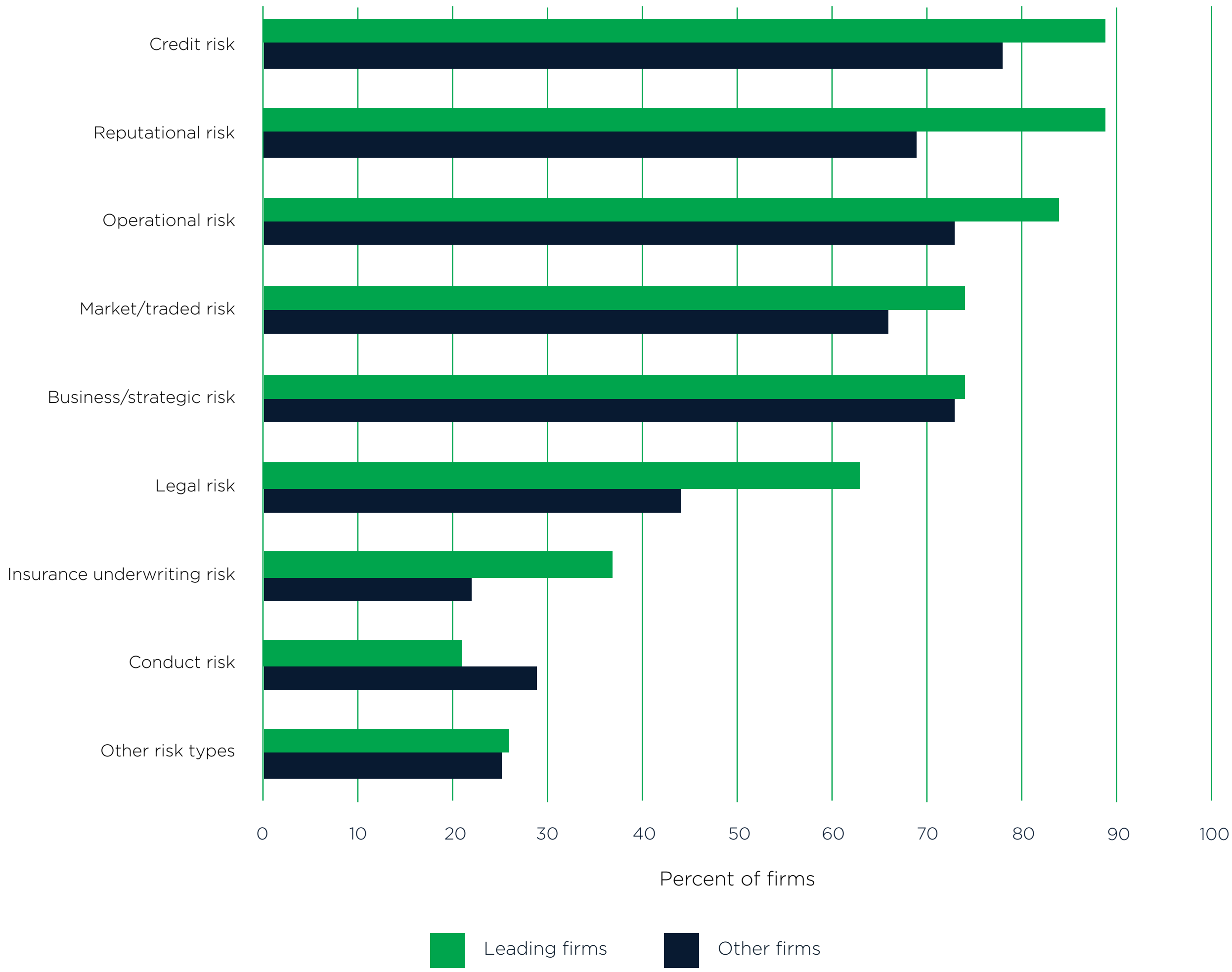
Nevertheless, regulation aside, it is still interesting to see how the leading firms distinguish themselves from the others from a risk management perspective.

The majority of leading firms' due diligence assesses the physical risk, transition risk, and greenhouse gas emissions associated with their counterparties, whereas only slightly more than half of the other firms assess this. Leaders are also more likely to assess whether their counterparties will help them meet portfolio temperature alignment or net-zero objectives.

Figure 5: Due Diligence of Counterparties' Climate Risk Coverage

Leading firms are more likely to consider climate risk as both a principal risk and as a factor in other risk categories — like credit, reputational, and operational. The exception to this trend is conduct risk, which is considered more of a climate risk factor by other firms than by leaders.

Figure 6: Risk Types That Climate Risk Is Considered Within



Taking the Next Steps: Metrics, Targets, Limits; Scenario Analysis; and Disclosures

This section looks at the dimensions where the leaders have made substantially more progress than the others — metrics, targets and limits; scenario analysis; and disclosures.

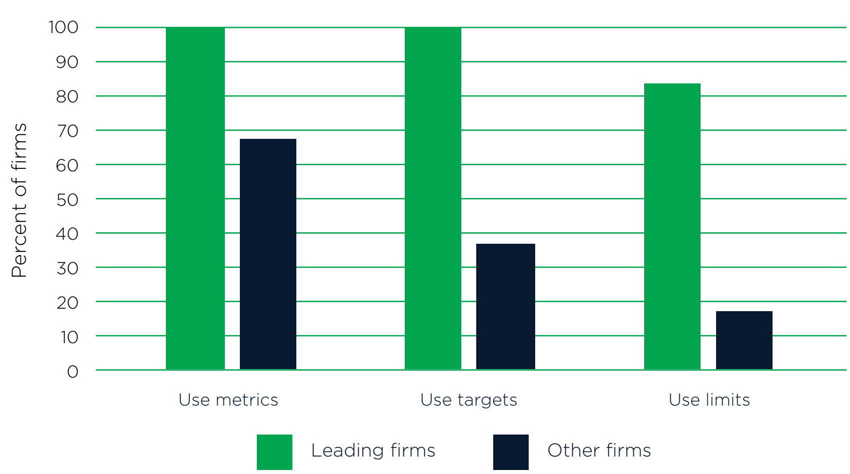
Metrics, Targets and Limits

For the survey, these terms were defined as follows:

- A metric is a measure used to assess climate risk.
- A target is the outcome the organization aims to achieve.
- Limits represent the worst outcome the organization is prepared to accept without taking corrective action.

All leaders use metrics and targets, and the majority of them use limits to manage their exposure to balance sheet asset and liability risks; measure portfolio alignment; meet fiduciary duties; and/or to understand the impact of their own organization on the climate.

Figure 7: Metrics, Targets, and Limits Usage



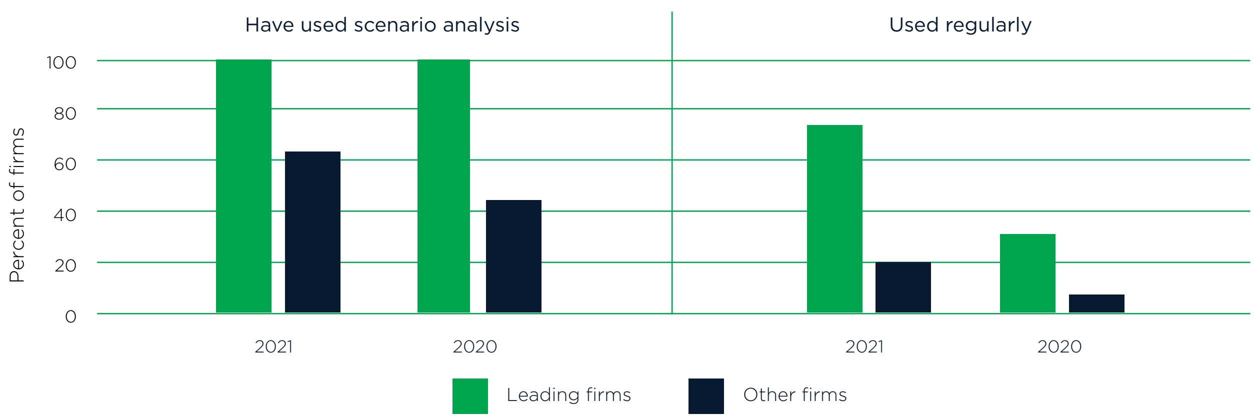
Leaders are much more advanced at embedding metrics within their organizations. For example, all leading firms reported that their climate-related metrics were aligned with the strategy of their organization, and most included the metrics within their risk management frameworks. Other firms have made relatively little progress on all aspects of setting targets and limits.

Scenario Analysis

All leaders have used scenario analysis to understand the impact of climate-related risk on their organization's portfolio or balance sheet, and the majority currently use it. In contrast, only slightly more than half of the others have used scenario analysis.

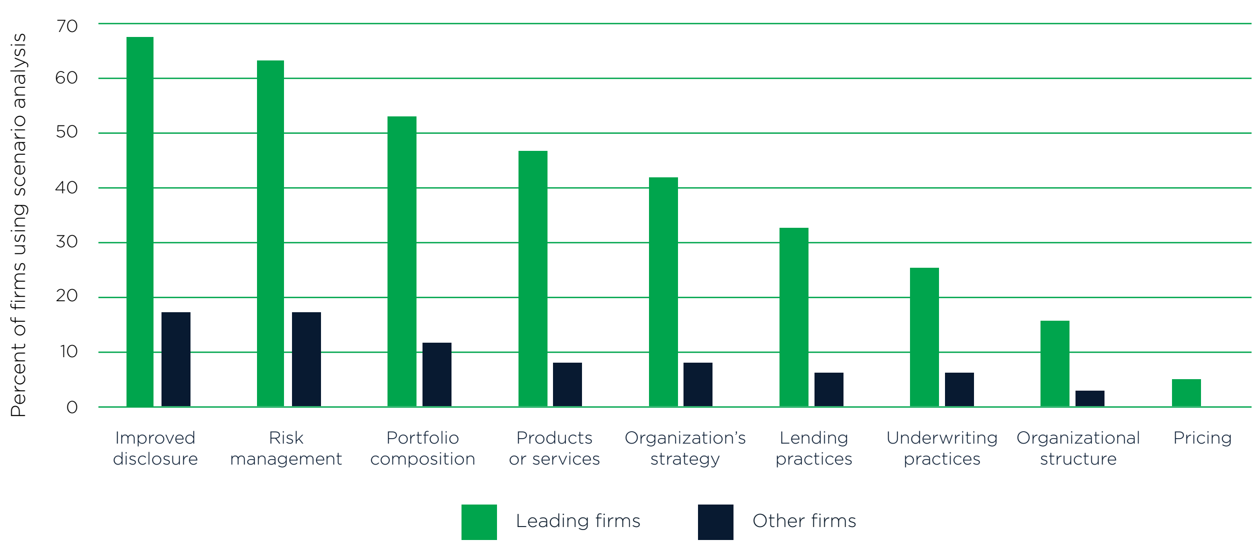
Leaders are also more likely to use it regularly (74%) compared with the others (20%). In addition, their regular use has increased significantly compared to the 2020 survey, when only 33% of the leaders and 8% of others used scenario analysis regularly.

Figure 8: Frequency of Firms' Scenario Analysis



What's more, leaders were more likely to take a range of actions, based on the findings of a scenario analysis, from changing risk management to revising the organization's strategy, products, and services (Figure 9).

Figure 9: Actions Taken After Doing Scenario Analysis



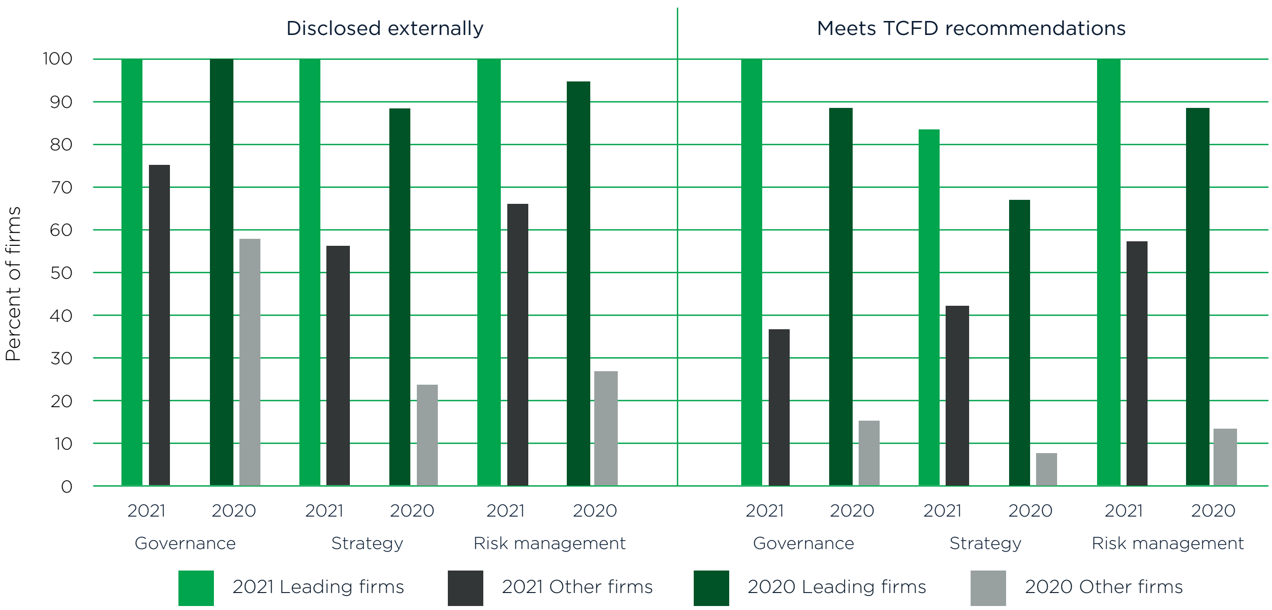
Compared with 2020, both leaders and others are using more time horizons in their scenario analysis.

Disclosure

While the regulators of the majority of firms require them to report about their climate-related risks, proportionately more of the leading firms are required to report (84% of leaders compared with 59% of others), which is probably also encouraging them to develop their risk management capabilities.

This year, all leading firms are externally making disclosures about governance, strategy, and risk management (an improvement from last year), and most leading firms stated that their disclosures meet the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD). Other firms have also increased their disclosures; however, most of them do not think their disclosures meet the TCFD recommendations.

Figure 10: External Disclosures and TCFD Recommendations



Conclusion

Overall, we have seen firms' climate risk management practices improve year-over-year, as both the physical and policy environments develop and regulators' focus on climate risk increases.

The focus from supervisors has no doubt contributed to the leaders being more advanced. That said, the gap between the leaders and the others has narrowed somewhat this year, especially for governance and disclosures.

It takes time to establish good climate risk management, and we expect to see leading practices continue to evolve. Firms that haven't yet started looking at climate risk in earnest would be wise to begin.

If you would like to participate in the 2022 survey and learn how your firm compares to its peers, please contact climaterisksurvey@garp.com before April 30, 2022.

About the Authors

Jo Paisley, President of the GARP Risk Institute (GRI), has worked on a variety of risk areas at GRI, including stress testing, operational resilience, model risk management and climate risk. Her career prior to joining GARP spanned public and private sectors, including working as the Director of the Supervisory Risk Specialist Division within the Prudential Regulation Authority and as Global Head of Stress Testing at HSBC.

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