GRI | Risk Institute

TODAY'S CLIMATE LEADERS:

What Are They Doing Right, and How Can Other Firms Follow?

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Firms that are leading the way in climate risk management have done so by embedding this risk into their day-to-day businesses, enhancing their risk management practices, and building engagement at board and senior management levels. In this paper, we highlight the approaches taken by these firms and the steps that others can take to join them.

At a Glance

KEY TAKEAWAYS

Firms that are leading the way in climate risk management have separated themselves from the pack by embedding this evolving risk into their day-to-day businesses, developing advanced risk management practices, and building engagement at board and senior management levels. It's not too late for firms that are just getting started in climate risk to catch up, but to gain insights for necessary improvements, they would do well to understand the foundational steps that leaders have taken and the challenges that lie ahead.

INTRODUCTION

For many in the financial industry, climate change represents a long-acknowledged, often-ignored source of potential risk. By virtue of its long time horizons, dispersed impacts, and volatile outcomes — plus a minimal emphasis from regulators — it was both easy and appealing to disregard climate change throughout much of the 2000s. Over the last five years, however, climate change has garnered increasing attention from both regulators and the financial industry alike, and that focus seems likely to continue growing.

For a firm new to climate risk, getting started may present a daunting task. Climate risk already represents a complex, multi-disciplinary field of study, and risk management practices are still in their early stages.

However, there are many firms that have started regardless, and some have made significant progress in meeting the challenges of climate change. To assist new firms, or a firm that aspires to be a leader, in building expertise and adapting to climate change's global implications, we explain the insights these examples offer.

SURVEY OVERVIEW

To produce a current snapshot of practices in the area of climate risk management, the GARP Risk Institute has for the past two years conducted an annual global survey of practices at financial institutions. As the survey is voluntary, the characteristics of responding firms may vary from those of the larger industry.

Seventy-one firms responded to the 2020 survey: 43 banks and 28 other financial institutions, comprising asset managers, insurers, and financial market infrastructure companies. These firms have a global footprint, cutting across all regions, and represent a considerable portion of the market, with $42 trillion of balance sheet assets and $36 trillion of assets under management.

The survey was structured to capture six key dimensions of firms' climate risk management: 1) **governance** and 2) **strategy** for dealing with actual and potential climate risks; 3) approach to **risk management**; 4) the **metrics, targets, and limits** used to assess and manage climate risks and opportunities; 5) the use of **scenario analysis** to understand the risks; and 6) climate risk **disclosures**.

After being scored up to a maximum of 100 for each of the risk dimensions, the firms were ranked by their total score. In the following sections of this paper, we refer to those that scored in the top 25% of all respondents as the financial industry's climate risk leaders.

State of the Industry

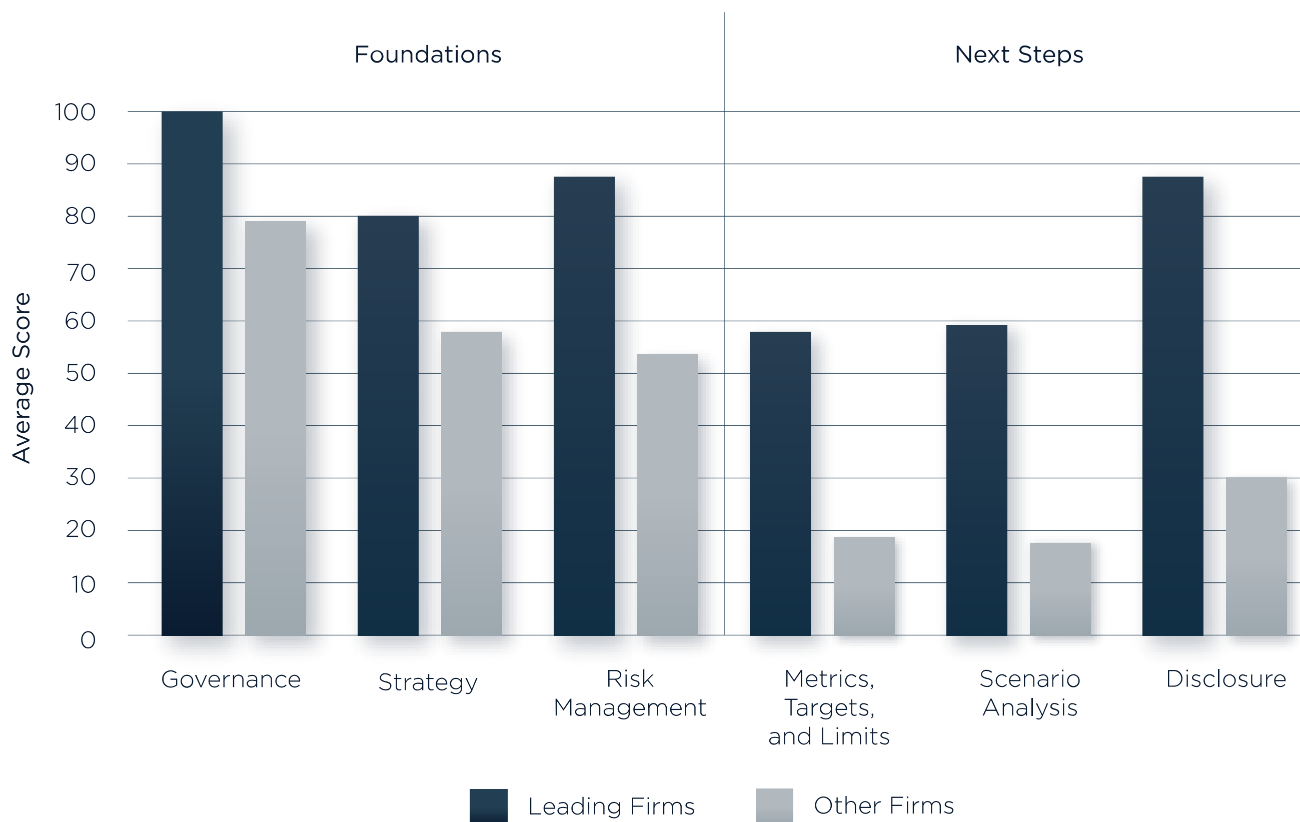
Before diving into the specifics of how leading firms differentiate themselves, it is first worth examining where these differences are most pronounced.

While climate risk leaders, on average, score better than the other firms in each risk dimension, the differences are much larger in some dimensions than in others. Most firms in our survey have made significant progress in the first three dimensions: governance, strategy, and risk management. Throughout this paper, we refer to these as *Foundations*.

In contrast, very few firms other than the leaders have made much progress in metrics, targets, and limits; scenario analysis; or climate-related disclosures. We refer to these three dimensions as *Next Steps*.

For a firm new to climate risk — or a firm that aspires to be a leader — seeing what the leading firms are doing can provide helpful insights on where to focus attention for driving improvement. In the following sections, we examine both *Foundations* and *Next Steps* for these insights.

Figure 1: What Makes a Climate Risk Leader?



How Did Climate Risk Leaders Get Where They Are Today?

The firms that distinguished themselves in our survey as climate risk leaders come from a wide array of geographies and business models. Their headquarters are dispersed across North America, the UK, Europe, and the Asia-Pacific region. They include banks (both global and regional), asset managers, and insurers.

In our survey, the length of time they have been considering climate risks was the single best predictor of which firms distinguished themselves as climate risk leaders. Typically, these leaders began considering climate risk much earlier than other firms, underscoring that it takes time to embed any new risk type into risk management frameworks. Firms new to climate risk management must be prepared to commit time and resources to building this capability.

Since a greater proportion of leading firms is required by their regulators to report climate-related risks, regulatory influence is another likely driver of the firms' advanced climate-risk-management capabilities. However, many of the lower-scoring firms in our survey are also required to report these risks, so the other drivers are also clearly important.

Figure 2: When Was Climate Risk First Introduced?

The Foundations: Governance, Strategy, and Risk Management

Many firms in the financial industry have taken their first steps toward reckoning with the impacts and financial risks arising from climate change. As with any new organizational effort, firms may confront a great deal of uncertainty about how or where to get started.

The exact approach will vary depending on each firm's specific business model, but our survey results suggest there are several dimensions to which all firms — including leaders and newcomers — need to attend.

GOVERNANCE

To coordinate and drive an effective set of climate risk initiatives, firms need to have a clear system of governance. Most firms in our survey have already made progress in this area. Almost all firms, for example, indicated that their board has oversight of issues related to climate change. Similarly, a large majority of respondents identified one or more C-level executives who are ultimately responsible for managing climate risk efforts. Due to their ubiquity, these traits can best be understood as a baseline or a bare minimum that a firm will need to meet if it wishes to start effectively building its climate risk capabilities.

Although board oversight of climate change efforts is very common, there is variance in the level of board involvement. Leading firms tend to involve their board more meaningfully in discussions about climate risk — often presenting them with papers or proposals for review. The more that leadership is involved in driving climate change initiatives, the more tangible and impactful the resulting programs will be.

STRATEGY

Almost all firms in our survey (over 90%) have begun considering the potential strategic effects of climate-related risks and opportunities. Most frequently, firms are concerned with the short-term strategic effects (1 to 5 years), but many firms are also considering the potential effects over the next 15 years and beyond. Climate risk leaders have separated themselves from the pack through the breadth and specificity of the plans they have made and the actions they have taken as a result of their strategic assessments.

In response to climate change's potential for disruption, most firms have begun taking clear steps to adapt their strategies. The majority of firms — and nearly all climate risk leaders — have developed short-term strategies that they expect to be robust for the next one to five years. As part of these strategies, many firms have begun the process of assessing and adapting their business practices. (See Figure 3 on the next page)

Most surveyed firms have begun assessing the potential impacts of climate change, but climate risk leaders have done so for more business attributes, as can be seen in Figure 3. Likewise, many firms have begun to actively adapt their business practices. This includes both altering existing products and launching new products, such as green bonds.

Figure 3: Strategic Actions in Response to Climate Change

RISK MANAGEMENT

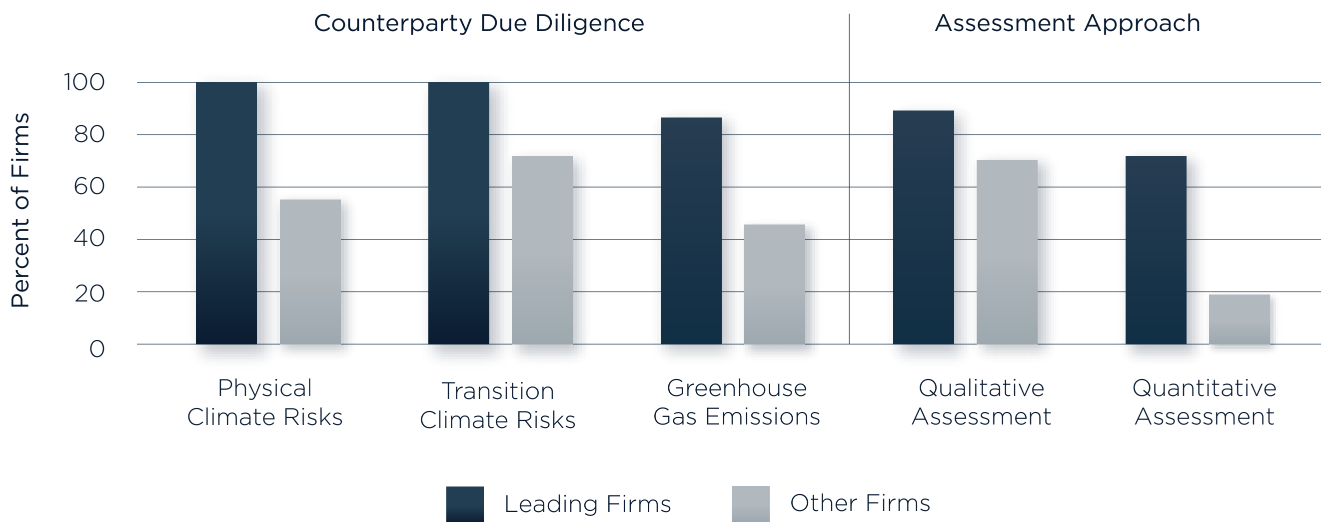
By incorporating climate considerations into their risk management frameworks, firms can take their strategic insights and begin turning them into concrete practices. Perhaps not surprisingly, most firms in our survey have recognized the importance of enhancing their risk management frameworks — though climate risk leaders have made substantially more progress.

Most firms, including all climate risk leaders, have designated senior staff members to lead their climate risk management functions. However, relatively few firms have established dedicated climate risk teams or functions. While having a dedicated team is not necessary, it does demonstrate organizational commitment.

For financial institutions, most of the financial risk associated with climate change derives from their counterparties or the companies in which the firms invest. As depicted in Figure 4, most financial firms have begun doing due diligence of their counterparties to assess the potential impacts from both the physical and transition risks of climate change. The counterparties' greenhouse gas emissions are also commonly assessed.

While the rigor of these counterparty assessments is unknown, we do have information on the approach firms are taking. As Figure 4 shows, most firms in our survey are relying solely on qualitative assessments; however, climate risk leaders are also likely to incorporate quantitative measures in assessing counterparties' climate risks — a step few of the other firms have taken.

Figure 4: Scope and Approach of Counterparty Risk Assessment



Foundational Challenges

Two key challenges that the majority of firms confront as they begin considering the implications of climate change are regulatory uncertainty and alignment across internal stakeholders. In response to our survey, both climate risk leaders and other firms indicated that each of these poses a significant challenge — in the short term and beyond. Any firms new to climate risk may meet with organizational paralysis in the face of these challenges.

Establishing a clear governance structure can help to mitigate the difficulties of internal alignment. Senior management involvement within a firm can not only foster accountability and strategic clarity but also allows for a more efficient distribution of knowledge throughout the firm. Many climate risk leaders that acknowledged internal alignment as a short-term challenge expect its significance to decline as individuals throughout their organizations become better informed on the disruptions posed by climate change.

In acknowledging the challenge posed by regulatory uncertainty, it is also important to recognize that climate change's negative effects will not wait for regulatory clarity. The process of strategic assessment and adaptation will inevitably be ongoing, and adjustments will be necessary as the impacts of climate change manifest and regulators respond.

Firms that begin the strategic assessment process sooner will be in a better position to build internal knowledge, engage with regulators, and respond agilely to a changing regulatory landscape.

Taking the Next Steps: Metrics, Scenario Analysis, and Disclosures

What are the real differentiators between the climate risk leaders and the other firms? Let's take a look.

METRICS, TARGETS AND LIMITS[1]

Metrics, targets, and limits are concrete commitments from firms to embed climate-related risks in their business management. However, this is a field in which fewer firms have made significant progress, perhaps because there aren't any standard climate risk measures yet.

All the leading organizations use metrics in their climate risk management, and they are much more likely than the others to use targets and limits. They are also significantly more likely to have embedded them into their organization's strategy and risk management, as illustrated in Figure 5.

Figure 5: Targets and Limits Use and Alignment

[1] 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.

The quantitative assessment needed to determine targets and limits takes longer to develop than qualitative aspects of risk management. Consequently, firms that want to improve their climate risk management are encouraged to start constructing metrics and embedding them in day-to-day business operations.

There is currently a wide range of practices in setting targets and limits. Within this wide range, the largest differentiator is that leading firms are more likely to set asset targets and limits at the sector/industry level, whereas only a minority of the other firms do this.

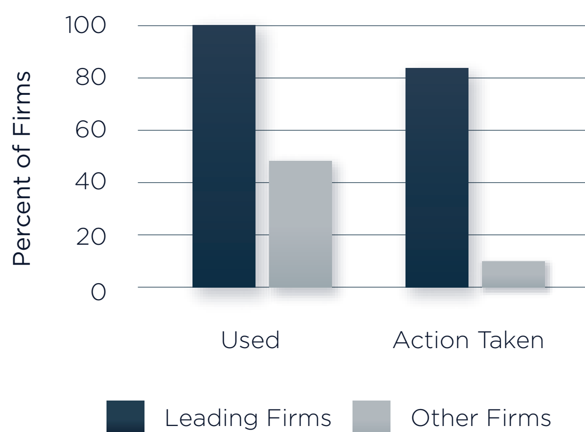
Nevertheless, all firms have much work to do if they want to develop a coherent set of metrics, targets, and limits that can be applied within a portfolio. Moreover, very few firms have geographical targets or limits, indicating that they do not have a set risk appetite for physical risk.

SCENARIO ANALYSIS

Given the high degree of uncertainty about how physical and transition risks will manifest and their potential severity, scenario analysis is a useful tool to explore a firm's risks in potential future scenarios.

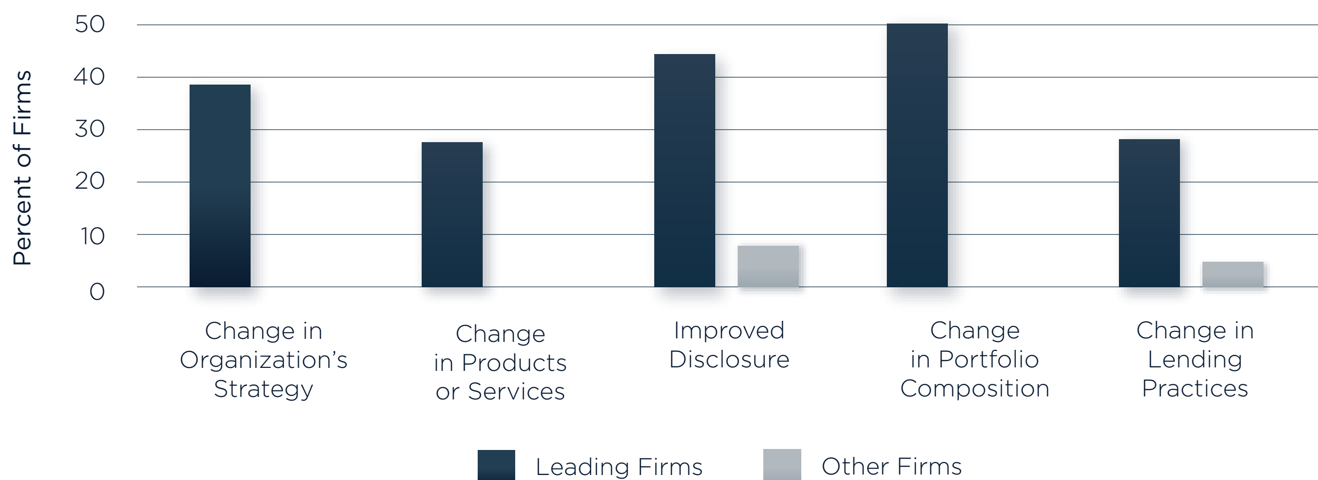
All leading firms use scenario analysis, either as a regular part of their risk assessment or on an ad hoc basis, as illustrated in Figure 6. And the majority of them have taken action as a result of their scenario analysis.

Figure 6: Use of Scenario Analysis



While the majority of leading firms have taken action after doing scenario analysis, they use the results in a variety of ways: from changing portfolio composition, to improving disclosures, to changing strategy, as shown in Figure 7. The types of action are diverse, and it is expected that an even greater variety of actions will be taken in the future.

Figure 7: Actions Taken After Scenario Analysis



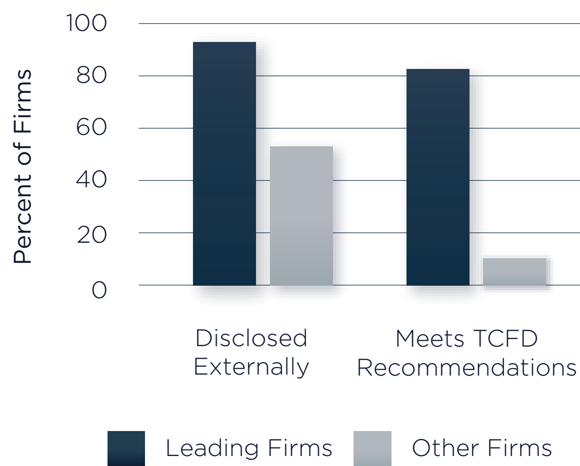
In conducting scenario analysis, the leading firms most frequently use a mix of both internal and external models, analyze scenarios over a range of time horizons, and utilize their existing stress testing infrastructures. While there is no consistent approach yet, they are building scenario analysis capability to embed it within risk management processes and to yield actionable results.

DISCLOSURES

While disclosure of a firm's practices in and of itself may not make that firm a better manager of climate risk, it does provide a measure of accountability by allowing stakeholders and outside entities to better understand the firm's position. As one of the three categories with the highest degree of differentiation, leading firms have made significantly greater progress in this regard than others.

As a consequence of the capabilities they have developed, leaders are much more likely to disclose externally and to have quality disclosures, as shown in Figure 8. As firms develop their climate risk management practices, disclosures need to keep pace to ensure that stakeholders are kept up to date with the financial risks to which the firm is exposed.

Figure 8: Disclosures



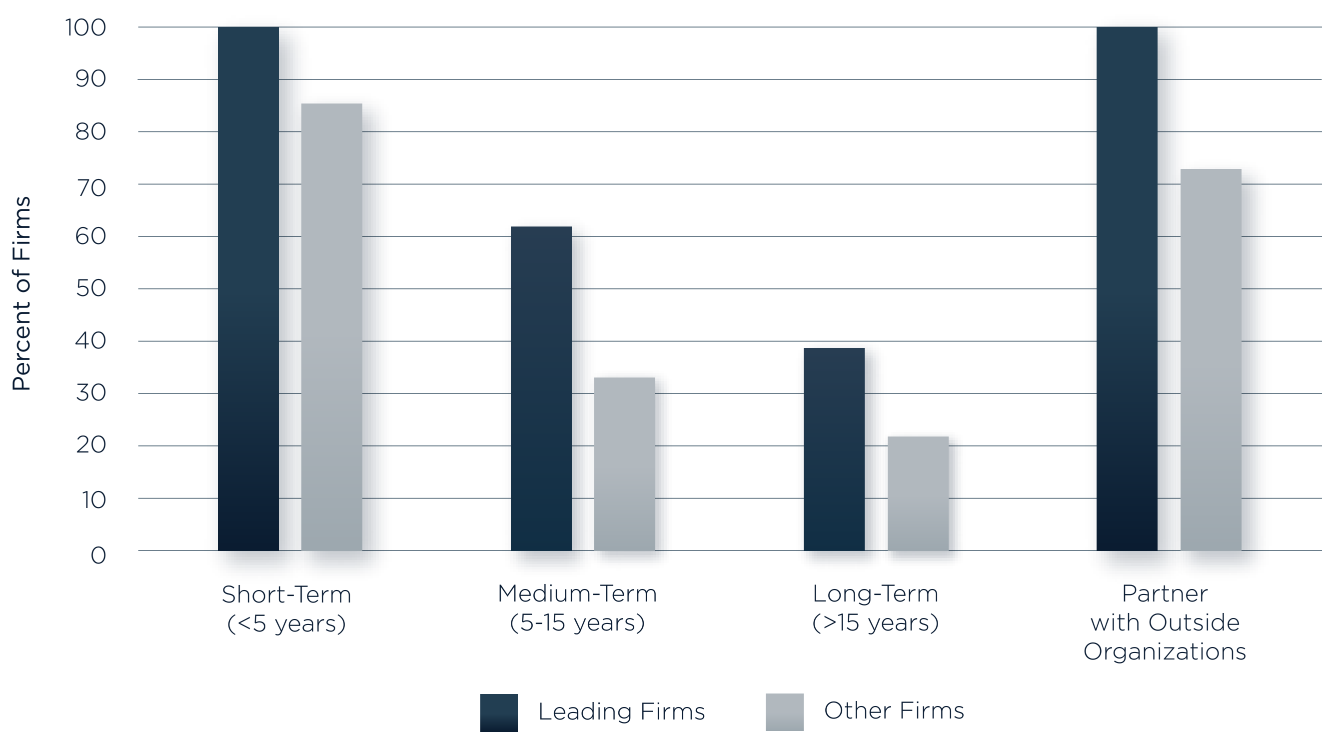
Growing Pains

Climate risk leaders are more likely to expect that the availability of reliable models will remain a significant challenge in the medium and long term. Since these leaders have already started grappling with the robustness of methods, data, and tools, they have more insight into the modeling obstacles and have a greater awareness of the challenges of forecasting factors, such as weather events and regulatory and technology changes. Less mature firms are more inclined to expect to use external parties to build models, which they think will need to be tailored to their business.

The need for ongoing model development or tailoring leads to another area of focus: the availability of qualified team members. Especially in the short term, many firms expect that it will be difficult to have enough staff who understand the financial risks that arise from climate change. To meet this challenge, firms need to invest in education and capability building from the board level down, throughout the organization.

Given the constant advancement in climate risk management practices, leading firms are focused on continually improving, with plans to build their capabilities over the next 15 years or beyond. Recognizing the specialized knowledge needed to realize these plans, leading firms universally intend to partner with third-party organizations (most commonly, consultancies and universities) to help grow this expertise.

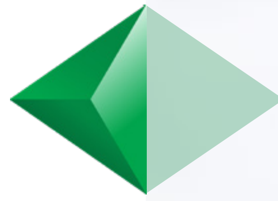
Figure 9: Plans to Expand the Organization's Climate Risk Capability



Call to Action

While climate change poses unprecedented challenges to the financial industry, firms that invest time and resources to prepare for its disruptions will be in a better position to meet these challenges and to capitalize on opportunities that appear along the way. With board-level engagement, leading firms are building climate risk management into their organizations. Moreover, they are adapting their strategies, changing their product offerings, building their climate risk management capability, and partnering with third parties to improve further.

Through these improvements, climate risk leaders will be able to set appropriate climate risk appetites, regularly monitor their risk through scenario analysis, shrewdly assess their counterparties and their investments, and disclose risks in a clear and meaningful way. The rest of the industry would do well to take notice.



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