Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

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Gobharnóir / Governor

Chairs and CEOs of Regulated Financial Service Providers

3 November 2021

Dear Chair, Dear CEO,

SUPERVISORY EXPECTATIONS OF REGULATED FIRMS REGARDING CLIMATE AND OTHER ESG ISSUES

The challenges associated with climate change and broader sustainability issues have significant implications for the economy as a whole, as well as for individual households and businesses and for the financial system. The attached annex sets out the Central Bank of Ireland's (Central Bank) supervisory expectations of regulated financial service providers (RFSPs) as they seek to comply with statutory and regulatory obligations on climate and broader environmental, social and governance (ESG) issues. RFSPs have an important role to play in climate transition and will have to increase their focus in this area.

The Central Bank's mission is to serve the public interest by maintaining monetary and financial stability while ensuring that the financial system operates in the best interests of consumers and the wider economy. We see addressing climate change as a strategic priority, and that the financial system has to be resilient to the risks it poses as well as having an important role to serve the needs of consumers and the wider economy in the transition to a carbon neutral future. We recognise that these issues are challenging, particularly as expertise and capabilities develop. Nevertheless, climate change does require action on the part of all participants in the financial sector. For those overseeing RFSPs, there is a need to lead and drive the climate and broader ESG agenda within their firms.

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Glasgow Declaration

The Central Bank intends to play its part in the change process alongside industry and our colleagues in the Network for Greening the Financial System (NGFS), a group of central banks and supervisors committed to sharing international best practice on climate and sustainability issues in the financial system. We and peers within the NGFS have today endorsed the 'Glasgow Declaration' reaffirming our commitment to international cooperation in addressing the challenge posed by climate change by sharing best practice and contributing to the development of environment and climate risk management in the financial sector, and mobilising finance to support the transition towards a sustainable economy.

Our supervisory approach

Our supervisory approach to climate and other ESG issues (which will continue to evolve) is informed by regulatory developments at EU level, the work of our peers and our broader supervisory objectives.

Climate considerations are a key component of the ESG agenda that the EU is seeking to address as part of its sustainability package of regulatory reforms. The EU Sustainability Framework provides a range of statutory and regulatory requirements relating to climate and other ESG risks that firms must adhere to. The Central Bank's approach in this area is aligned to – and consistent with – the requirements under the EU's framework, as well as with developments and relevant rulebooks at EU level for banks, insurers and asset management firms. The NGFS' framework for supervisory engagement with firms on climate matters has also informed our thinking (along with the supervisory activities of peer regulators on climate and other ESG issues).

More broadly, the Central Bank's supervisory objectives seek to:

- promote high levels of trust and confidence in the financial system, ensuring that customers are treated fairly and consumer and investor interests are protected;
- pursue the orderly functioning of markets based on transparent and fair price formation;
- ensure all firms have sustainable business models, sufficient financial resources (including through times of stress), are well governed (with appropriate cultures and effective risk management) and can recover if they get into difficulty (or are resolvable if they fail).

In line with these objectives, the Central Bank will be focused on ensuring compliance with climate and wider ESG related statutory and regulatory obligations and on effective climate risk mitigation. We must also ensure the orderly functioning of markets and wider market integrity, particularly in the development of sustainable finance and the prevention of 'greenwashing'.

Our supervisory expectations

The Central Bank's supervisory expectations (as set out in the annex) apply to all RFSPs as defined under Section 2 of the Central Bank Act 1942. They are articulated on the basis that they can be applied by RFSPs in a proportionate manner aligned to the nature, scale and complexity of the individual firm. Consequently, our expectations are not prescriptive in nature, and they are not set out at a granular level of detail. It is important to note that while our expectations are based upon international best practice, they are not binding upon firms. Our expectations do not replace or override any legal, regulatory or supervisory requirements applicable to firms, and it is a matter for firms to seek their own legal advice if they are unsure of their own obligations.

Our supervisory expectations focus on five key areas:

- **Governance:** firms need to demonstrate clear ownership by their Boards of climate risks affecting the firm and to promote a culture that places emphasis on climate and other ESG issues;
- **Risk management framework:** firms need to understand the impact of climate change on the risk profile of the firm and to enhance their existing risk management frameworks to ensure robust climate risk identification, measurement, monitoring and mitigation;
- **Scenario analysis:** scenario analysis and stress testing are critical to assess the impact of potential future climate outcomes, including impacts on capital adequacy, where applicable;
- **Strategy and business model risk:** firms are expected to undertake business model analysis to determine the impacts of climate risks (and opportunities) on the firm's overall risk profile, business strategy and sustainability, and to inform strategic planning; and
- **Disclosures:** existing legal requirements on disclosure emphasise the importance of transparent disclosure to consumers and investors to protect their interests and wider market integrity. In particular, firms need to ensure they do not engage in the practice of 'greenwashing'.

Conclusion

I acknowledge the challenge that adhering to the range of statutory and regulatory requirements relating to climate and broader ESG issues presents. Our approach will evolve and we will keep it under review (including consideration of the need for sector-specific guidance). It will be based on our regulatory and supervisory experience, engagement with industry and evolving international developments and best practice in line with the Glasgow Declaration.

To facilitate engagement, the Central Bank will establish a Climate Risk and Sustainable Finance Forum (the Climate Forum) which will bring together stakeholders to share knowledge and understanding of the implications of climate change for the Irish financial system. This will enable the sharing of best practice on embedding climate risk and sustainable finance considerations within firms. I expect the Climate Forum's first meeting to take place in the first half of next year, and we will provide further details about it in the near future.

Climate change is a critical issue for society. The financial system must play its part in addressing it and firms can expect follow-up from the Central Bank, including engagement through the new Climate Forum and interaction on a range of broader regulatory and supervisory perspectives. I look forward to working with you to meet the challenge that climate change poses to all of us.

Yours sincerely,

Gabriel Makhlouf

Annex

Central Bank of Ireland – Supervisory Expectations of Regulated Firms[1] regarding Climate and ESG risks[2]

Within the context of the sector legislative requirements relating to climate and broader ESG issues, as firms seek to address their compliance and build their resilience whilst also ensuring the interests of consumers and investors are protected, we have identified five areas of focus for firms:

1. Governance: firms need to demonstrate clear ownership by the Board[3] of climate risks affecting the firm. They are required to ensure the Board oversees climate risk proactively through business strategy and risk appetite, with adequate resourcing and clear roles and responsibilities assigned for Boards, board sub-committees and senior management as appropriate. We acknowledge that the required level of resourcing and expertise may need to be strengthened over time, on a basis that is proportionate to the nature, scale and complexity of firms. Firms may also consider establishing specific climate or sustainability units. Where climate risks are material for the firm, or where gaps in understanding are present, specialist expertise to advise the Board is encouraged. More broadly, we expect the Board and senior management to be proactive in taking action to promote a culture that places emphasis on climate and broader ESG issues consistent with the financial sector's important role in supporting the transition to a carbon neutral future.

2. Risk management framework: firms need to understand the impact of climate change on the risk profile of the firm and to enhance their existing risk management frameworks to ensure

[1] **Significant Institutions** (SIs) are supervised by the European Central Bank (ECB) within the Single Supervisory Mechanism. Such firms are referred to the ECB's Guide on Climate-Related and Environmental Risks (the Guide), which outlines detailed supervisory expectations for SIs to consider climate-related and environmental risks when formulating and implementing their business strategy, governance, and risk management frameworks, and disclosure practices. In December 2020 the Central Bank issued a letter to Less Significant Institutions (LSIs), outlining our plans to use the Guide as a basis for on-going supervisory engagement in a proportionate manner. For SIs in particular, nothing in this letter supersedes the supervisory expectations contained in the Guide or the ECB's follow-up supervisory engagement in that regard. These institutions are also important from a domestic financial stability and consumer/investor protection standpoint, and therefore they are expected to consider the content of this letter as they seek to address climate and wider sustainability issues.
In 2019 EIOPA published their opinion on the integration of sustainability in Solvency II. This work focussed on Pillar 2 requirements, such as risk management, governance and the ORSA. In April 2021, EIOPA published its opinion on climate change risk scenarios in the ORSA to support both insurers and supervisors in effectively assessing, managing and mitigating climate related risks. In late 2020, a Climate & Emerging Risk Survey was issued to a sample of firms across the Irish insurance sector to assess awareness, understanding and management of climate related risks. A report 'Understanding the future of Insurance' summarises the key findings.
Amendments to the UCITS Directive, AIFMD and MiFID II clarify existing obligations in relation to sustainability risks, and address other aspects of sustainability. Asset management firms are also subject to the new sustainability transparency requirements under the SFDR and the Taxonomy Regulation.

[2] Environmental considerations might include climate change mitigation and adaptation, as well as the environment more broadly, for instance the preservation of biodiversity, pollution prevention and the circular economy. Social considerations could refer to issues of inequality, inclusiveness, labour relations, investment in human capital and communities, as well as human rights issues. The governance of public and private institutions – including management structures, employee relations and executive remuneration – plays a fundamental role in ensuring the inclusion of social and environmental considerations in the decision-making process.

[3] The term "Board" should be taken to include partners and principals in unincorporated entities.

robust climate risk identification, measurement, monitoring and mitigation. This should be supported by relevant management information and risk reporting which should enable the Board to discuss, challenge and take decisions relating to the firm's management of climate risks. Climate risks are expected to impact across the suite of risks that the firm seeks to manage through its three lines of defence. Firms' control functions should assess the effectiveness of the firm's climate risk management and internal controls, including alignment with the Board's stated risk appetite.

3. Scenario analysis: scenario analysis and stress testing are critical to assess the impact of potential future climate outcomes, including impacts on capital adequacy, where applicable. Lessons from the recent pandemic highlight the importance for firms of preparing for downside risks. The consequences of climate risks should not be viewed as tail risk events that are unlikely to materialise or require urgent action. Scenarios should include differing transition paths to a carbon neutral future, as well as a path where no transition occurs. Approaches to scenario analysis will need to evolve and mature over time. Accessing the right data will be critical to this. The extent of firm scenario analysis and stress testing should be proportionately aligned to the nature, scale and complexity of the business, and the materiality of climate risks impacting the firm.

4. Strategy and business model risk: firms are expected to undertake business model analysis to determine the impacts of climate risks (and opportunities) on the firm's overall risk profile, business strategy and sustainability, and to inform strategic planning. Insights from scenario analysis and stress testing should feed into the strategy setting process, to support assessment of the future viability of the business model in transition. Business model changes will likely include the development of new products and services and the marketing of the sustainability features of new and existing products and services to consumers and investors. Firms need to ensure that they adhere to the requirements under applicable EU legislation and regulation in the development and design of such products and services, as well as ensuring they meet the criteria prescribed in those frameworks regarding disclosure (see below). Firms are also expected to give due consideration to the potential consumer and investor protection consequences of such products and services.

5. Disclosures: the legal requirements on disclosure are clear that firms need to ensure they do not engage in 'greenwashing'. They must adhere to transparency and disclosure principles and requirements (where applicable) including the Taxonomy Regulation[4], the Non-Financial Reporting Directive (to be updated by the proposed Corporate Sustainability Reporting Directive[5]) and the Sustainable Finance Disclosures Regulation[6], together with other relevant European Supervisory Authority (ESA) requirements. Firms are expected to disclose information and data on the climate-related risks they are exposed to, their potential impact on financial and operational resilience and how they plan to manage and mitigate such risks. Public disclosure by firms relating to climate and other sustainability/ESG risks contribute to wider market integrity. Asset managers and investment product providers are responsible for providing disclosures to their clients and customers on the sustainability risks and where relevant, impacts of investment products. They must ensure that such disclosures are clear, fair and not misleading.

[4] Under the Taxonomy Regulation (EU Regulation 2020/852), the objectives of Climate Change Mitigation and Climate Change Adaptation apply from 1 January 2022, with the remaining four objectives applying from 1 January 2023.
[5] The proposed Corporate Sustainability Reporting Directive contains amendments to the existing Non-Financial Disclosures Directive (EU Directive 2014/95/EU).
[6] EU Regulation 2019/2088.