

Response to the Public Consultation on OSFI Draft Guideline

**Re_Generation
B-15 Climate Risk Management**

Although OSFI's Draft Guideline B-15 represents a step in the right direction, its overall approach suffers from many conceptual flaws which will prevent the new rules from playing a substantive role in ensuring the climate resilience of the Canadian economy. The incremental changes that OSFI proposes in its draft guideline, which amount to little more than improved transparency and disclosure methods and vague or unenforceable recommendations in lieu of actual policy, will not be sufficient to accelerate the economic changes that are needed to avoid the worst of the climate disruption that the Canadian economy now faces.

The stranded asset risk present in the Canadian financial system presents an enormous challenge to our collective future. According to a study published in Nature Energy, half the world's fossil fuel assets could be financially worthless in the future, and that this could happen as early as 2036¹. In the upstream oil and gas sector alone, transition risk will likely cost over \$1 trillion². This presents a disproportionately large risk for Canada; according to the Canadian Climate Institute, 70% of Canada's goods exports, and 60% of our foreign direct investment, come from sectors that are transition-vulnerable³. Unfortunately, Canada's economy is not transitioning appropriately. Although we require around \$70 billion per year to fund green projects and meet our net-zero commitments, we currently invest only around C\$10 billion per year in green initiatives⁴. At the same time, our five largest banks have provided over \$910 billion to the fossil fuel industry since the signing of the Paris Agreement in 2015⁵. Evidently, private capital markets are not shifting to align our economy with net zero, which presents an existential challenge for future generations of Canadians. Without strong and robust public policy to resolve this problem, it is not likely that the Canadian economy will be prepared for either the threat of climate disruption or the opportunities presented by the global green transition.

OSFI's guidelines are not ambitious or stringent enough to properly attenuate stranded asset risk in Canada's financial system. In particular, we are concerned about the following overarching issues:

1. Failure to consider systemic risk, double materiality, or integrate the precautionary principle;
2. Failure to go beyond self-regulation and outline specific normative guidelines centred on a 1.5 degree pathway;
3. Failure to consider other regulatory instruments;
4. Failure to integrate appropriate timelines reflecting the urgency of the crisis.

Addressing stranded asset risk is a public interest matter that individual firms are not empowered to act on, which accordingly means that OSFI must intervene to stop the firms' activities that give rise to stranded asset risk in the first place. Delaying the implementation of ambitious climate policy only increases the risk faced by firms, and by Canadian depositors, further down the road. Given this reality, and the severe time constraints associated with our global 1.5 degree pathways, OSFI must significantly improve its draft guidelines to reflect the need for greater regulation and allocative credit policy, specific requirements for aligning with 1.5 degree scenarios, mandating adherence to clear and credible low carbon transition plans, and other suggestions as detailed in the ensuing response.

1 Gregor Semieniuk et al, "Stranded fossil-fuel assets translate to major losses for investors in advanced economies," Nature Climate Change 12, 2022, <https://www.nature.com/articles/s41558-022-01356-y>.

2 Ibid.

3 Canadian Climate Institute, "Sink or Swim: Transforming Canada's Economy for a Global Low-Carbon Future," 2021, <https://climateinstitute.ca/reports/sink-or-swim/>.

4 Smart Prosperity Institute, "Canadian Pensions Dashboard for Responsible Investing," 2021, <https://institute.smartprosperity.ca/sites/default/files/Pensions-Dashboard.pdf>.

5 Rainforest Action Network, "Banking on Climate Chaos," 2022, https://www.ran.org/wp-content/uploads/2022/03/BOCC_2022_vSPREAD-1.pdf

1. Failure to consider systemic risk, double materiality, or integrate the precautionary principle as enshrined in the Canadian Environmental Protection Act.

OSFI's proposed guidelines fail to address the stranded asset risk due to systemic climate risk because they fail to address or regulate the root cause of these stranded asset risks, which are the impacts of firm behaviour on the climate system. The reason for this failure is that the OSFI guidelines do not integrate a double materiality perspective, which thus prevents firms from ascertaining the causal connection between their financing of climate destabilization and the risks they face as a result of these disruptions. In other words, **OSFI is compelling firms to quantify and disclose their climate risks without actually taking action to limit the sources of that risk in the first place.**

Double materiality recognizes both the climate risks to financial institutions and the climate implications of the financial institutions' activities. Double materiality is the only way to conceptualize the systemic risks associated with climate change, which include stranded asset risk, as these systemic risks are themselves a product of firms' financial activities. Without considering double materiality, which explicitly recognizes the causal interrelationship between firms' climate impacts and the emergence of climate risks, OSFI will be unable to fulfill its mandate to minimize the systemic risks posed to the Canadian economy by abrupt climate change.

At a fundamental level, stranded asset risk is a reflection of the systemic, unpredictable, and non-linear nature of the climate crisis, associated in particular with the feedback loops that exist between both climate change and other environmental problems (i.e. biodiversity loss), and also between the climate system and the volatile nature of complex human societies. The problem with these risks is that they are impossible to measure; they are reflections of uncertainty, not risk. Where risk is quantifiable, uncertainty is not (by definition). Mainstream climate stress tests or scenario analysis **do not incorporate the most severe risks associated with climate destabilization**, which include the catastrophic but unquantifiable consequences of economic and social breakdown that make attempts to perfectly and meticulously model the future little more than speculation. In this context, regulators must be able to **take decisive and bold action to curb firms' climate impacts before the full financial and institutional consequences of climate disruption can be fully modeled and anticipated.**

The inevitable nature of stranded asset risk emerges ultimately from the unquantifiable risk of economic and social disruption. As Finance Watch has observed,

“When financial institutions provide capital to fossil fuel facilities, exploration and production, they incur the risk linked to the unavoidable decline of the value of fossil fuel enterprises, either because fossil fuel reserves will stop being exploited in an attempt not to exhaust the planet's carbon budget, or because their continued exploitation will take the planet beyond the global warming tipping point and thus trigger a global economic and financial meltdown” (Finance Watch 2020).

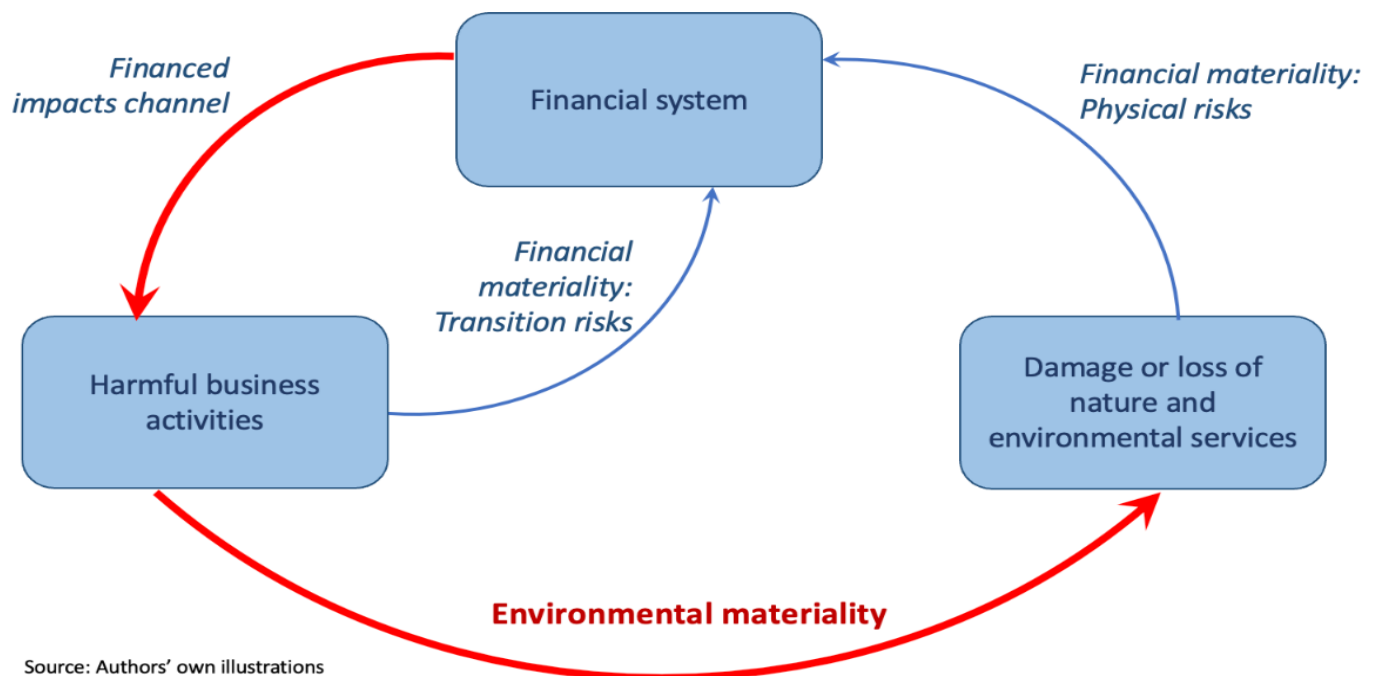
The Bank of International Settlements recognizes that “the deep uncertainties involved and the necessary structural transformation of our global socioeconomic system are such that no single model or scenario can provide a full picture of the potential macroeconomic, sectoral and firm-level impacts caused by climate change.” The Network for Greening the Financial System has identified the systemic nature of this challenge, and the difficulty of measuring it, in its work on ‘green swans’, which are defined as disruptive shocks due to abrupt environmental change that are both extremely likely but whose effects are highly uncertain. Luiz Awazu Pereira da Silva, Deputy General Manager of the Bank of International

Settlements, writes that:

“Faced with sets of events that are complex, subject to radical uncertainty but with the likelihood of a massive future impact, **Green Swans call less for improvements in risk modelling and more for decisive and immediate action and coordination**” (Bank of International Settlements 2020).

In situations where the uncertainty associated with climate models is difficult to model, the double materiality perspective becomes immediately helpful as a **means to use firms’ climate impacts as a proxy variable for the determination of climate risk**. As outlined in the following diagram, the negative impacts of financial firms’ activities on both the climate and the biosphere serve as a reliable proxy for understanding the physical and transition risks of ecological collapse at a systemic level.

Negative impacts of finance offer a proxy for understanding accumulation of physical / transition risks at the systemic level



(Source: Kedward et al. 2022).

Accordingly, adopting a double materiality approach would both empower OSFI to take bolder action to attenuate the root causes of climate risk while also serving as a superior means of overcoming the deep informational uncertainties associated with modelling humanity’s collective future. Within the remit of a double materiality lens, OSFI would more appropriately consider the problem of financed emissions and take a more active role in shaping capital allocation at Canadian financial institutions. Most importantly, a double materiality perspective would allow OSFI to take a precautionary approach to the problem of making Canada’s economy resilient to climate change, by empowering it to **take more decisive regulatory action in line with the precautionary principle that is already embedded in Canadian law through the Canadian Environmental Protection Act**.

A double materiality perspective is also more relevant for financial institutions themselves, as they conduct their own climate risk assessments. When considering social and environmental issues and how they affect business activities, **double materiality is the most decision-relevant perspective for in-**

vestors and preparers. This is because a double materiality perspective allows for the identification and attenuation of potential environmental and social risks before they become material financial risks, which makes it proactive rather than reactive. Double materiality is a more long-term approach when compared to single materiality, and it is this characteristic which makes it better at future-proofing business strategies against potential risks emerging from unstable social and environmental systems. There is often a 'time lag' between an environmental issue becoming important to investors and thus material within the enterprise value paradigm; by adopting a double materiality perspective, investors are provided with that information more quickly. At the same time, without a double materiality lens there is the danger that certain risks will not be considered material until it is simply too late to act on them. In the case of climate risk, while an enterprise value lens might appear sufficient for firms with a short investing time horizon, this could potentially lead to the lock-in of a significant amount of high-emitting infrastructure that might become stranded assets in the future but appear profitable given today's constraints. Firms looking to make strategic investments in a low-carbon future on a multi-decade timescale will require a double materiality lens.

Major organizations, including the UN Principles of Responsible Investment, have joined these calls. Eric Usher, the head of the United Nations Environment Programme Finance Initiative (UNEP FI) has proclaimed that the **financial materiality approach is insufficient**, saying that the "exclusive focus" on financial risk has created a "short-term outside-in approach to materiality" which will not drive systemic change. The Transition Pathway Initiative has also written that "using financial materiality as a criterion for reporting can downplay or underemphasize important aspects of corporate performance, in particular those where the impacts or the costs are not borne by the company itself. It can also mean that issues that are seen as important by stakeholders, in particular those stakeholders who are not recognized as important by the company, are downplayed or ignored" (Transition Pathway Initiative 2020).

For further research about double materiality, systemic risk, stranded assets, and financial regulation, see the following works cited:

Katie Kedward et al, "Biodiversity loss and climate change interactions: financial stability implications for central banks and financial supervisors," *Climate Policy*, July 2022, <https://www.tandfonline.com/doi/full/10.1080/14693062.2022.2107475>.

Katie Kedward et al, "Managing Nature-Related Financial Risks: A Precautionary Policy Approach for Central Banks and Financial Supervisors," UCL Institute for Innovation and Public Purpose, 2020, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3726637.

Hugues Chenet et al, "Finance, climate-change and radical uncertainty: Towards a precautionary approach to financial policy," *Ecological Economics* 183, May 2021, <https://www.sciencedirect.com/science/article/pii/S092180092100015X>.

Nick Taylor, "Making financial sense of the future': actuaries and the management of climate-related financial risk," *New Political Economy*, April 2022, <https://www.tandfonline.com/doi/full/10.1080/13563467.2022.2067838>.

Jean Boissinot et al, "Aligning financial and monetary policies with the concept of double materiality: rationales, proposals and challenges," *The Inspire Sustainable Central Banking Toolkit*, June 2022, <https://www.lse.ac.uk/granthaminstitute/wp-content/uploads/2022/06/INSPIRE-Sustainable-Central-Banking-Toolbox-Policy-Briefing-Paper-5.pdf>.

Finance Watch, "Breaking the climate-finance doom loop: How banking prudential regulation can tackle the link between climate change and financial instability," 2020, https://www.finance-watch.org/wp-content/uploads/2020/06/Breaking-the-climate-finance-doom-loop_Finance-Watch-report.pdf.

Bank for International Settlements, "The Green Swan: Central Banking and Financial Stability in the Age of Climate Change", 2020, <https://www.bis.org/publ/othp31.pdf>.

Bank for International Settlements, "Green Swan 2 – Climate change and Covid-19: reflections on efficiency versus resilience, 2020, <https://www.bis.org/speeches/sp200514.pdf>.

Agnieszka Smoleńska and Jens van 't Klooster, "A Risky Bet: Climate Change and the EU's Microprudential Framework for Banks," Journal of Financial Regulation, April 2022, <https://academic.oup.com/jfr/article/8/1/51/6562598>.

Hugh Miller and Simon Dikau, "Preventing a 'climate Minsky moment': environmental financial risks and prudential exposure limits," Grantham Institute, March 2022, <https://www.lse.ac.uk/granthaminstitute/wp-content/uploads/2022/03/Preventing-a-climate-Minsky-moment.pdf>.

Transition Pathway Initiative, "TPI Position Paper on the efforts towards Comprehensive Corporate Reporting by CDP, CDSB, GRI, IIRC and SASB," 2020, <https://www.transitionpathwayinitiative.org/publications/67.pdf?type=Publication>.

2. Failure to go beyond self-regulation and outline specific normative guidelines centred on a 1.5 degree pathway.

While OSFI's proposed guidelines instruct firms to both disclose climate risk and institutionalize risk management processes, OSFI does not actually outline what those specific processes should be, nor does it mandate adherence to a specific subset of practices that are intended to align with a climate-safe future as defined by the 1.5 degree pathways outlined in the Paris Agreement. **In absence of specific regulation mandating firms to align their capital with a climate-safe future, OSFI's guidelines rely excessively on disclosure and increased transparency to shift capital markets, an approach which is tantamount to self-regulation and will not be effective in moving capital flows towards a sustainable economy.**

OSFI's commitment to "principles based" guidance means that outside of the annexes, there are no specific standards to hold financial institutions accountable. This lack of specific standards makes robust enforcement impossible and undermines the usefulness and comparability of the information that financial institutions are being asked to disclose. Within OSFI's current approach, it is sufficient for firms to disclose their risk management process, but **there is no guidance about how risk management should be undertaken, or how to determine if it is fit-for-purpose.** OSFI does not take a position about the specific strategies that firms should adopt, with reference to preferred future scenarios, and instead simply states the parameters for how firms' actions should be communicated. In particular, OSFI outlines no requirements for firms to adopt science-based emissions reductions targets that are 1.5 degree aligned, no specific guidelines around what constitutes a clear and credible low-carbon transition plan, and no specific guidelines around which scenarios to use for the purpose of scenario analysis (i.e. the IEA Net-Zero Scenario). Firms can disclose the climate change scenarios they use, but there is no guidance about what climate scenarios should actually be used, or how scenario analysis should actu-

ally be performed. Moreover, the decision by OSFI to depart from the use of internationally developed scenarios, such as the IEA 1.5 degree scenario, and instead instruct firms to use a unique scenario developed by OSFI for the Canadian market, will only serve to further fragment and distance Canadian firms from their international peers.

While Principle 1 of the draft states that financial institutions should have Climate Transition Plans, it fails to specify what metrics make up a credible plan. Simply relying on the elements of a transition plan as outlined by the TCFD is extremely insufficient. At the very minimum, OSFI should outline a requirement for credible transition plans that include comprehensive financed emissions disclosure, absolute short and medium-term emissions reductions targets covering all scopes of emissions in line with limiting warming to 1.5°C, quantifiable decarbonization strategies with interim targets set in five year increments, and accounting for a just transition including respect for Indigenous Rights. OSFI should also include guidelines for firms to minimize their use of carbon offsets and negative emissions technologies in lieu of mitigation actions. For further information on the elements of a scientifically credible low-carbon transition plan, see [Re_Generation's Company Transition Toolkit - Guide on Climate Change](#).

If OSFI is intending to streamline firms' climate risk disclosures and improve both granularity and comparability, then more detail is needed, encompassing precise recommendations with specific guidelines around preferred practices. For example, the EFRAG Climate Standard Prototype describes seven key disclosures that firms should report on, and identifies specific and objective performance metrics to use alongside guidance on what approaches to use in disclosing those metrics.

OSFI should also clarify the specifications around certain parameters of the disclosure standard which remain vague and unclear, including the following:

- When OSFI instructs firms to "monitor and report on internal targets to assess the FRFI's progress," there should be clear guidance about what these targets are, what indicators should be used, and whether or not they are science-based;
- When OSFI asks firms to adopt "sufficient capital and liquidity buffers," there should be much more guidance around what exactly determines the sufficiency of a capital or liquidity buffer, with specific reference to their sufficiency in relation to a 1.5 degree Paris-aligned future;
- When OSFI instructs firms to "use results as an input into its capital and financial planning processes, where appropriate," there should be additional clarification around what specific capital allocation decision-making and planning practices should be altered, and in what manner;
- When OSFI instructs firms to use a "range of plausible and relevant scenarios," there should be clear guidance around what scenarios should be used, with specific reference to internationally developed scenarios that are Paris-aligned, accompanied by an explanation of how scenario analysis should be performed;
- With respect to the ISSB cross-industry metric regarding "description of incorporation of climate risk factors into credit analysis," significant additional guidance must be provided around how this analysis should be performed, and what criteria should be used, including whether or not credit practices are Paris-aligned;
- In the Disclosure Category - GHG Emissions as it regards Scope 3 emissions, it should be made clear that this includes accounting for clients and investees Scope 3 emissions, as required by the Net Zero Banking Alliance.

In addition, Principle 2 states that financial institutions should have appropriate governance, but does not address the conflicts of interest that many institutions foster by choosing Board members with ties to polluting industries. Financial institutions should be required to link Senior Management compensation to achievement of climate goals and publish that policy along with other key disclosures.

Finally, all disclosures against OSFI scenarios, including methodologies and core assumptions, should be made public in the interest of maintaining accountability and transparency. With regards to where and when climate disclosure takes place, we advocate that at a minimum it be included in the financial institution's financial reports, and be made available at least immediately coinciding with the end of the fiscal year.

3. Failure to consider other regulatory instruments.

The approach outlined in OSFI's draft guidelines rely too much on disclosure in lieu of actual policies designed to shift credit allocation. Simply relying on disclosure and information-sharing to move markets is akin to asking firms to self-regulate. According to Finance Watch, "transparency measures cannot reduce on their own the macro-prudential risks that fossil fuel financing causes by enabling climate change, if anything because private agents are not responsible for the public interest" (Finance Watch 2020). By essentially delegating the responsibility to act on climate change to private sector actors, deferring to their individual decisions and strategies, OSFI is neglecting its public duty to attenuate the systemic risks to the Canadian financial system by providing guided regulation in a uniform and comprehensive way.

There are a suite of alternative policy instruments that OSFI could use, in its capacity as a financial regulator, to limit stranded asset risk by winding down fossil fuel investments and accelerating green investments. These policies can be grouped under the auspices of a "green allocative credit policy" regime that sees the use of market-shaping tools, such as differentiated risk and capital requirements or outright activity prohibitions, as an underlying prerequisite for preserving financial stability (Kedward et al 2022). Through the use of sector-specific green targets on price and conditions of credit, as well as sector-specific targets on quantity of credit or credit growth, financial regulators can work to align their policy toolkits with government climate targets in a way that sees net-zero alignment as a core function of climate risk attenuation. As economist Katie Kedward writes,

"Instead of conceptualising the green transition as a static efficiency optimisation problem requiring only price corrections – as is implicit within the risk-based framework – alternative approaches frame decarbonisation as a 'wicked problem' (Rittel and Webber, 1973) involving dynamic structural change, encompassing multiple sectors and agents, supply and demand dynamics, lock-in effects, and uniquely predicated upon the complexities of rapidly deploying and diffusing technological innovation" (Kedward et al 2022).

In the interest of creating a green allocative credit policy regime, OSFI has numerous tools at its disposal. The following policies could be used in the interest of reforming the banking system:

- Direct policies
 - Interest rate floors and ceilings
 - Subsidized credit for households/SMEs/priority sectors
 - Portfolio restrictions: outright bans financing certain sectors/assets
 - Credit quotas
 - Lending ratios
 - Large-scale public investment (e.g. through systemically important banks)
 - Favourable loan-to-value/debt-to-income ratios
- Indirect policies
 - Capital requirement adjustments
 - Reserve requirement adjustments

- Credit guarantees
- Dirty-penalizing factors for global systemically important banks
- Large exposure limits
- Countercyclical capital buffer
- Sector-targeted refinancing lines
- Collateral haircut adjustments
- Tilting in asset purchase programmes

For institutional capital, OSFI could also consider policies from the following suite of tools:

- Direct policies
 - Portfolio restrictions, including:
 - Outright bans on financing certain sectors/alternative assets
 - 100% repo haircuts on dirty collateral
 - Mandatory exclusion of dirty assets from (ESG) indexes for passive investment
 - Ineligibility of certain assets for securitisation
 - Forced sale of dirty assets to state 'bad bank'
- Indirect policies
 - Capital requirements for allocations to dirty (alternative) assets
 - Punitive leverage ratio
 - Collateral haircut adjustments
 - Margin requirement adjustments

For more information about financial regulation for the green transition, see the following works cited:

Ameli, N., Drummond, P., Bisaro, A., Grubb, M. and Chenet, H. (2019). Climate finance and disclosure for institutional investors: why transparency is not enough. *Climatic Change*.

Campiglio, E., Dafermos, Y., Monnin, P., Ryan-Collins, J., Schotten, G. and Tanaka, M. (2018). Climate change challenges for central banks and financial regulators. *Nature Climate Change*, 8(6), pp.462–468.

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Oustry, A., Erkan, B., Svartzman, R. and Weber, P.F. (2020). Climate-related Risks and Central Banks' Collateral Policy: a Methodological Experiment [Online]. Banque de France. Available at: https://publications.banquefrance.fr/sites/default/files/medias/documents/wp-790_0.pdf.

Dafermos, Y., Gabor, D., Nikolaidi, M., Pawloff, A. and van Lerven, F. (2020). Decarbonising is easy: Beyond market neutrality in the ECB's corporate QE [Online]. New Economics Foundation. Available at: <https://neweconomics.org/uploads/files/Decarbonising-is-easy.pdf>.

Dafermos, Y., Gabor, D., Nikolaidi, M. and van Lerven, F. (2021). Greening the UK financial system – a fit for purpose approach [Online]. SUEF The European Money and Finance Forum. Available at: https://www.suerf.org/docx/f_55c6017b10a9755ef3681b09ccb01e94_21233_suerf.pdf.

Schoenmaker, D. and Van Tilburg, R. (2016). What Role for Financial Supervisors in Addressing Environmental Risks? *Comparative Economic Studies*, 58(3), pp.317–334.

D'Orazio, P., Popoyan, L. and Monnin, P. (2019). Prudential Regulation Can Help in Tackling Climate

Change. Council on Economic Policies Blog. [Online]. Available at: <https://www.cepweb.org/prudential-regulation-can-help-intackling-climate-change/>.

Miller, H. and Dikau, S. (2022). Preventing a 'climate Minsky moment': environmental financial risks and prudential exposure limits. Grantham Research Institute on Climate Change and the Environment, LSE. Available at: 30 <https://www.lse.ac.uk/granthaminstitute/wp-content/uploads/2022/03/Preventing-a-climate-Minsky-moment.pdf>.

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Mikheeva, O. and Ryan-Collins, J. (2022). Governing finance to support the net-zero transition: Lessons from successful industrialisations. Institute for Innovation and Public Purpose Working Paper Series. (WP2022/1).

Ryan-Collins, J. (2019). Beyond voluntary disclosure: why a 'market-shaping' approach to financial regulation is needed to meet the challenge of climate change [Online]. SUERF: The European Money and Finance Forum. Available at: https://www.suerf.org/docx/f_a821a161aa4214f5ff5b-8ca372960ebb_4805_suerf.pdf.

Schnabel, I. (2021). From green neglect to green dominance? Available at: https://www.ecb.europa.eu/press/key/date/2021/html/ecb.sp210303_1~f3df48854e.en.html.

4. Failure to integrate appropriate timelines reflecting the urgency of the crisis.

Finally, OSFI's draft guidelines ask firms to implement the relevant changes at a timeline that is far too lax and does not reflect the urgency of the climate crisis. For example, waiting until 2027 to implement scenario analysis is far too late. There are a multiplicity of international scenarios that have already been developed and can be used for this purpose, and it is not necessary for OSFI to spend additional time developing its own scenario that is only going to further entrench Canada's position as a laggard relative to international peers. 2027 is also much too late for the disclosure of Scope 3 emissions, which should begin as soon as possible.