Annex

Good practices on climate-related risk governance

In December 2021, the Hong Kong Monetary Authority (HKMA) issued Supervisory Policy Manual (SPM) module GS-1 on "Climate Risk Management", which sets out its supervisory expectations on climate risk management. The SPM module GS-1 provides high-level guidance to authorized institutions (AIs) on climate risk management, while allowing flexibility for AIs to tailor their own approaches to develop and enhance their framework and processes[1].

The HKMA undertook a set of supervisory activities, including thematic examinations and consultative sessions[2], to review selected AIs' (participating AIs') progress in implementing the supervisory expectations set out in SPM module GS-1, with a focus on climate-related risk governance. The HKMA engaged both locally incorporated AIs and foreign bank branches (FBBs) through these two complementary exercises.

We gained useful insights into how participating AIs develop and augment their governance frameworks, taking into account their size, structure and business, to fulfil the HKMA's supervisory expectations. A robust governance framework facilitates the effective oversight of climate-related risks and the healthy and sustainable growth of their climate-related businesses.

This annex summarises key observations and provides a set of good practices in relation to climate-related risk governance identified by the HKMA over the course of its supervisory exercises. Part A summarises our key observations and good practices for developing a robust governance structure to set out the responsibilities of the Board and senior management (i.e. good practice #1). Part B summarises our key observations and good practices for ensuring robust oversight on the key aspects of climate-related risk issues (i.e. good practices #2-9). These good practices may serve as a reference for AIs in considering further enhancements to their climate-related risk governance frameworks and processes.

A. Developing a robust governance structure to set out the responsibilities of the Board and senior management

Key observations

All participating AIs have embedded climate risk considerations into their governance structure, having regard to the scale, nature and complexity of their business and operations in Hong Kong. At a minimum, these AIs have expanded the existing roles and responsibilities of the relevant governance bodies to include the consideration of climate-

[1] The HKMA allowed a 12-month period for the implementation of the GS-1 requirements.

[2] The HKMA conducted as series of consultative sessions to review AIs' progress in implementing the SPM module GS-1 on "Climate Risk Management", covering climate-related governance, strategy, risk management, and disclosures. Under this exercise, the HKMA discussed with the bank management their work on climate risk management and reviewed the information shared by them.

related matters. The board and senior management have been tasked with the primary responsibility for the oversight of an AI's approach to managing climate-related risks and opportunities. Participating AIs have also reviewed and enhanced their policies and official delegation documents (such as Terms of Reference, role description/mandate documents, etc.) to ensure all relevant parties' climate-related roles and responsibilities are clearly defined and updated in a timely manner.

<u>Good practices</u>

1. Enhancing governance structures to manage climate-related risks and opportunities

Some participating AIs have enhanced their governance structure in the following ways:

- Establishing dedicated committees to support the oversight of climate-related issues

    - Some locally incorporated AIs have set up dedicated sustainability or climate committees at the board- and/or management-level for managing climate-related risks and opportunities. These committees, which have clearly defined mandates, carry out the oversight of a variety of climate-related functions including climate- or ESG-related strategy, climate risk management, green and sustainable business development, etc.

    - The oversight of climate-related issues at participating FBBs situated in Hong Kong is carried out jointly by their local senior management and the relevant governance bodies at the banking group level. These banking groups usually set up dedicated committees and/or governance forums at the local, regional and group levels including the associated communication mechanisms and escalation processes to ensure effective oversight and proper risk management. Representatives of some FBBs participate in these forums and committees to report and exchange climate-related information with the group or regional management. Some FBBs also incorporate climate risks as a required item in the regular communication with their regional offices and groups to facilitate timely and responsive coordination and actions.

- Creating cross-functional working groups to coordinate climate-related tasks

    As climate-related initiatives often require contributions from and coordination across functions and departments within an institution, most participating AIs have set up cross-functional groups at the working level to facilitate the implementation of relevant initiatives. These cross-functional working groups are usually chaired by the AIs' senior management and comprise heads of various risk and business departments and functions. For instance, some AIs tasked their working groups with implementing regulatory requirements on climate risk management, including the SPM module GS-1; while in another case, an AI has set up multiple working groups for operationalising different climate-related initiatives that are part of its sustainability strategy.

- Keeping the governance structure under on-going review

  Some participating AIs review their governance structure and framework for climate risk regularly, taking into account the evolving climate-related policy landscape, market developments and changes in their climate-related strategies. Examples of enhancements made by these AIs as a result of their ongoing reviews include establishing new committees/departments/working groups to address business and operational needs, streamlining reporting processes, and expanding the scope of duties of relevant parties.

- Ensuring adequate discussions of climate-related matters at the board and senior management level

  - The board, relevant board-level committees and local management committees of some participating AIs frequently discuss climate-related matters to ensure they are addressed in a timely manner. Some AIs also include climate- or ESG-related issues as a standing item on the agenda of these committees' regular meetings.

  - Some AIs have enhanced their management information system (MIS) reports to facilitate oversight and monitoring of climate-related risks and opportunities by the board and management. These reports usually contain qualitative and quantitative information on transition and physical risks, international and local regulatory developments related to climate risk, updates on climate risk stress testing exercises and results, developments in green and sustainable finance, and progress updates on climate strategy implementation.

B. <u>Ensuring robust oversight on the key aspects of climate-related risk issues</u>

With appropriate governance structure in place, some participating AIs also established mechanisms to ensure the board and senior management exercise effective and adequate oversight of climate strategy, climate risk management, and the cultivation of institutional climate risk culture.

(I) Fostering and overseeing the effective development and implementation of climate strategy

<u>Key observations</u>

Most participating AIs or their banking groups have developed an explicit climate strategy to guide their actions. These climate strategies are usually set in alignment with national and/or jurisdictional climate policies, the strategies of the AIs' home jurisdiction and/or the commitments of the international and industry initiatives to which the AIs belong (e.g. Net Zero Banking Alliance).

Good practices

2. **Setting clear climate goals in line with global and local developments**

- Most participating AIs or the banking groups to which they belong have set climate goals, the granularity of which varies depending on the circumstances of each individual AI. Some AIs have committed to achieving net zero in their operations and financing portfolios with interim targets, aligning with the 1.5 °C limit referenced in the Paris Agreement. Some AIs established sectoral decarbonisation goals in absolute- or intensity-based terms based on science-based pathways for selected high-emitting sectors. Many AIs also include green and sustainable finance targets in their climate goals, which reflect their commitment to assist their customers in their low-carbon transition journey.

- In addition to group-level commitments and goals, some local subsidiaries of foreign banks or FBBs also set their own local strategies which align with strategies at the group and/or regional level. Even though specific local-level targets may not be assigned to these AIs by their group or regional management, one AI was observed to have made reference to the relevant regional pathways to benchmark their progress against their respective group's sectoral decarbonisation and financed emissions targets.

3. **Conducting an effective strategic assessment to inform the formulation of climate strategy**

- Many locally incorporated participating AIs conduct regular materiality assessments as part of their process to evaluate their strategic positions with regard to climate risks and opportunities, with one AI adopting the double materiality concept in the assessment. During their materiality assessment process, these AIs have engaged both internal and external stakeholders to identify climate- or sustainability-related topics that are most relevant and material to their business and operations, which in turn inform the development of their climate strategies. Some AIs also make their strategic assessment more comprehensive, for example, by analysing the impact of climate risk on the eight inherent risk types over the short, medium and long term, referencing the results of their climate risk scenario analysis and stress testing, and incorporating climate- or ESG-related risk considerations into their ICAAP review on a trial basis.

- For participating FBBs, while many leverage the group-wide strategic assessments, some of them take an additional step to conduct their own qualitative and quantitative climate-related materiality assessments, taking into account local circumstances to better inform their local strategy development and implementation.

4. Devising an appropriate action plan and deploying adequate resources to support the implementation of climate strategy

- Some participating AIs have devised appropriate action plans to support the implementation of institutional climate goals and strategies. These action plans usually comprise specific and concrete milestones and measures over different time horizons, such as:

  - reducing greenhouse gas (GHG) emissions through efforts to reduce energy consumption in the AI's own operations, and progressively reducing financed emissions (i.e. some AIs have set out a roadmap and milestones by baselining or stocktaking financed emissions levels, establishing sectoral decarbonisation targets, and developing tiered client engagement approaches, etc.);
  - supporting clients' transition by providing various green and sustainable solutions;
  - strengthening engagement with relevant stakeholders (e.g. clients, industry peers, policymakers, etc.) in pursuit of collective efforts to achieve climate goals;
  - regularly reviewing and enhancing internal processes and procedures for climate-related tasks;
  - improving climate- and ESG-related data systems through efforts including holistic analyses of data and system gaps, concrete action plans to address identified gaps with clearly defined timelines and expected deliverables; and
  - recruiting talents and building capacity by providing targeted climate or ESG-related training.

- Some AIs develop Key Performance Indicators (KPIs) or other measures, which are compiled into an integrated report, to facilitate the monitoring by the board and/or senior management on the AIs' progress against their action plan.

- Some AIs also review and update their action plans periodically in response to changes in their strategies, business conditions, as well as market and regulatory developments.

(II) Exercising appropriate oversight of climate-related risk management

<u>Key observations</u>

All participating AIs have incorporated climate-related risk considerations into their risk management frameworks to govern the process of identifying, assessing, monitoring, and controlling climate-related risks. These AIs, or the banking groups to which they belong have, at a minimum, articulated their climate risk appetite in qualitative terms to accord importance to this risk factor. They have also updated their risk management policy frameworks by establishing a standalone climate risk management policy and/or incorporating climate-related considerations into existing policies, whilst keeping them under regular review. Participating AIs have been progressively embedding climate-related risk considerations in the management of the traditional risk types, with the embedment into credit risk assessment and management being prioritised due the materiality of the associated risks.

<u>Good practices</u>

5. Developing and monitoring quantitative metrics for inclusion in the climate risk appetite statement (RAS)

- Having established a qualitative climate RAS, some AIs have taken the additional step of incorporating quantitative metrics in their climate RAS to govern their risk taking activities and facilitate board and senior management oversight. Some examples of these quantitative RAS limits or metrics include the concentration of credit exposures to high-emitting sectors, the amount of collateral vulnerable to physical risks, and the size and growth of the green and sustainable finance portfolio.

- While most participating FBBs adhere to their group-level climate RAS, some AIs also developed their own local RAS which takes into account branch-level considerations while also aligning with their group's RAS and climate strategy. Adherence to the local climate RAS is monitored and periodically reported to the local senior management.

- Some AIs have quantitative metrics or limits that are part of their business-as-usual (BAU) monitoring which are not incorporated in their climate RAS. They regularly review and assess the materiality of their climate risk profile and their readiness (e.g. data quality) for inclusion into their RAS.

6. Developing appropriate tools for embedding climate risk considerations in credit risk assessment processes

- Participating AIs have included assessments of climate-related risks in their credit evaluation and review processes through the use of a number of tools.

  - *Climate/ESG risk questionnaires*: Many AIs designed their climate or ESG risk questionnaires by making reference to the "Non-listed Company Questionnaire on Climate and Environmental Risk" jointly developed by the Green and Sustainable Finance Cross-Agency Steering Group (CASG) and CDP.

- *Internal climate/ESG-related risk rating or scoring frameworks*: Some AIs have developed a framework to assign climate/ESG-related risk ratings to their clients according to a defined set of factors including the client's climate risk profile, financial materiality of the client to the AI, and their low-carbon transition strategy where appropriate. In some cases, a climate risk override is introduced to the clients' credit risk rating based on the climate/ESG risk rating result.

- *Enhanced due diligence and client engagement*: Some AIs have also conducted enhanced due diligence for clients from high-emitting sectors and those assessed to have a higher exposure to climate risk based on the AI's climate risk assessment. For instance, some AIs have put in place a mechanism to ensure that potentially high climate/ESG risk clients are subject to more rigorous review by a dedicated sustainability team (either in the AI's second line of defence (LoD) or a group-wide function). Some AIs have also begun assessing the transition plans of clients from high-emitting sectors and stepping up client engagement efforts to ensure that transactions are consistent with their climate-related strategies and commitments.

(III) Cultivating a strong organisational climate risk culture

<u>Key observations</u>

The board and senior management of participating AIs constantly work on cultivating a strong climate risk culture within their respective organisations by embedding climate-related considerations into their performance evaluation frameworks, enhancing communication with internal and external stakeholders, and capacity building.

<u>Good practices</u>

7. Embedding climate-related considerations into performance evaluations and remuneration frameworks

- Some AIs have embedded climate-related considerations into their institution-wide performance evaluations with the relevant assessment criteria set out for the board, senior management and general staff, proportionate to their respective roles and responsibilities.

- A balanced consideration of both risks and opportunities (e.g. development of green and sustainable finance) related to climate/ESG is reflected in the performance scorecards for staff across different functions.

8. Offering training tailored to roles and responsibilities of its staff and setting out climate and ESG-related training requirements

- Some participating AIs offer climate- and ESG-related training on to their directors, senior management, as well as other general staff according to their roles and responsibilities. They rely on a combination of internally-developed and externally-sourced training. Some AIs also provide training through more flexible means (e.g. self-paced online courses with proper training record) to promote wider participation across the institution.

- Some AIs take additional measures to ensure that their staff have received sufficient training by setting out mandatory duration-based requirements on climate and ESG-related training. These training requirements help to equip staff with the necessary knowledge to carry out their daily tasks.

9. Promoting timely and transparent communication on climate-related issues with internal and external stakeholders

- In addition to embedding climate-related considerations into their business operations and risk management processes, some AIs organise internal staff sharing sessions on various climate-related topics, issue newsletters, and hold internal campaigns to raise the awareness of staff on climate-related risks and opportunities.

- Some AIs have published climate-related disclosures aligned to the TCFD recommendations. Participating AIs also closely monitor developments in climate-related disclosure practices and standards, and some AIs have started to explore aligning their disclosures accordingly.

- While most participating FBBs rely on their group-level climate-related disclosures, some AIs have also made efforts to prepare and publish local-level climate-related disclosures which provide a line of sight into their Hong Kong operations.