

EFFECTIVE RISK MANAGEMENT OF CLIMATE-RELATED FINANCIAL RISKS GUIDELINES



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1.0 Introduction

Climate change and the transition towards a low carbon economy are relevant to the Central Bank of Seychelles (CBS)' mission in maintaining monetary and financial stability. The physical effects of climate change and environmental degradation as well as the transition towards a low carbon economy can create financial risks and economic consequences, which affect:

1. the safety and soundness of the entities that the CBS regulates;
2. the stability of the financial system; and
3. the economic outlook in a way that could have a bearing on the appropriate monetary policy stance.

Accordingly, it is imperative that regulated institutions take active steps to address climate-related financial risks.

Taking cognisance of the opportunities and pervasive nature of climate-related financial risks, the CBS deems it important for the regulated institutions to include climate-related financial risks as part of their comprehensive risk management framework. Therefore, in line with the principles issued by the [Basel Committee on Banking Supervision](#) as well as best practices published by the [Network for Greening the Financial System](#), this Effective Risk Management of Climate-related Financial Risks Guidelines (hereafter referred to as the Guidelines) is being issued as a first step towards the recognition and management of climate-related financial risks by the regulated institutions.

The Guidelines is being issued in accordance with section 4A(2)(b) of the CBS Act 2004 (as amended). It is intended to be applied on a proportionate basis, considering the size, nature and complexity of the regulated institutions, their overall risk appetite/tolerance, and the materiality of climate-related financial risks. Notwithstanding, the regulated institutions may consider the [Nationally Determined Contribution of Seychelles](#) in their business models, strategies and risk appetites, as relevant.

To note, regulated institutions are required to establish appropriate risk management and governance frameworks where the relevant risks are material. For regulated institutions where climate-related financial risks are not material, they may not establish dedicated risk management, compliance and internal audit frameworks that focus on climate-related financial risks as laid down in these Guidelines. However, the roles and responsibilities of the Board of Directors and Senior Management with regards to identifying, measuring, monitoring, and managing climate-related financial risks, as laid down in these Guidelines, would be applicable.

2.0 Scope and Application

2.1 Application

The Guidelines apply to regulated institutions as defined herein.

2.2 Date and Scope of Application

The Guidelines is applicable as of its date of publication. Regulated institutions are expected to consider the extent to which their current risk management processes and practices for climate-related financial risks are sound, effective and comprehensive in light of the expectations set out in the Guidelines. Where this is needed, regulated institutions should start enhancing their risk management processes and practices. The CBS acknowledges that the management of climate-related financial risks and also the methodologies and tools used to address them, are currently evolving and are expected to mature over time. Hence, the Guidelines will be updated, as and when required.

3.0 Purpose

The Guidelines aim to:

1. provide guidance to regulated institutions on the components of climate-related financial risks in order to implement appropriate governance and risk management practices to effectively identify and manage these risks;
2. enhance and strengthen the resilience of the financial sector to climate-related financial risks as well as support the national agenda in transitioning towards a low carbon economy;
3. address any weaknesses in the management of climate-related physical and transition risks, which can adversely impact the safety and soundness of the individual regulated institutions as well as the stability of the overall financial system in Seychelles.

4.0 Definitions

In the Guidelines:

Board of Directors means the highest body of authority in an institution responsible for the strategic guidance of the regulated institution, the effective monitoring of its management, and accountability to its shareholders.

Central Bank means the Central Bank of Seychelles established by the Central Bank of Seychelles Act, 2004 (as amended).

Climate-related financial risks mean risks posed by the exposure of the regulated institution to physical and transition risks caused by or related to climate change. This may include damage caused by extreme weather events or a decline in asset value in carbon-intensive sectors.

Management means persons having authority and responsibilities for planning, directing and controlling the activities of the regulated institution, directly or indirectly, including any directors (whether executive or otherwise of the institution).

Physical risks mean economic costs and financial losses resulting from the:

- a) increasing severity and frequency of extreme climate change-related weather events (or extreme weather events) such as heatwaves, landslides, floods, wildfires and storms (that is, acute physical risks);
- b) longer-term gradual shifts of the climate such as changes in precipitation, extreme weather variability, ocean acidification, rising sea levels and rising average temperatures (that is, chronic physical risks or chronic risks); and
- c) indirect effects of climate change such as loss of ecosystem services (for example, desertification, water shortage, degradation of soil quality or marine ecology).

Regulated institutions means commercial banks, credit unions and non-bank credit granting institutions.

Transition risks means the potential economic adjustment cost resulting from policy, legal, technology and market changes to meet climate change mitigation and adaptation requirements.

5.0 Requirements

5.1 Governance

- a) The responsibility for the sound and prudent management of a regulated institution's business operations and related risks rests with its governance body. The regulated institution's Board of Directors should have strong governance arrangements supported by its corporate culture. In that respect, the Board of Directors are responsible for the effective and successful oversight of the management of climate-related financial risks and the monitoring of the exercise of the delegated functions and activities. The delegation arrangements should include clear assignment of the delegated responsibilities and mechanism for monitoring the exercise of the delegated authority. The Board of Directors should be able to evidence their ongoing oversight of these risks and ensure that material risks are disclosed in the regulated institution's annual report.
- b) The Board of Directors and Senior Management should clearly identify and assign responsibilities throughout the regulated institution's organisational structure for managing climate-related financial risks. The regulated institution may either establish an internal risk committee or expand the scope of existing risk committees for identifying the changing risk landscape and responding to climate-related financial risks.
- c) The Senior Management should develop comprehensive policies and processes, approved by the Board of Directors, that will assist in identifying climate-related financial risk drivers and assessing the potential impacts thereof on the regulated institution and the environment in which they conduct business.

- d) The Board of Directors and Senior Management should identify material climate-related financial risks over various time horizons¹, and incorporate the identified risks into its regulated institution's risk profile, risk management policies and practices, as well as overall business strategy and financial planning process.
- e) The Board of Directors and Senior Management should have an adequate understanding of climate-related financial risks and be equipped with the appropriate skills and experience to provide oversight and manage these risks. Regulated institutions should build capacity and train the Board of Directors, Senior Management and relevant staff on understanding and managing climate-related financial risks relevant to the regulated institution.
- f) The Board of Directors and Senior Management should ensure that their internal strategies and risk appetite statements consider climate-related financial risks and are consistent with any publicly communicated climate-related strategies and commitments. These should be regularly reviewed given the evolving nature of climate-related financial risks.
- g) Regulated institutions should incorporate climate-related financial risks into their internal control frameworks across the three lines of defence to ensure sound, comprehensive and effective identification, measurement and mitigation of material climate-related financial risks.

5.2 Risk Management

a) Integrated Approach

- i. The regulated institution could be potentially affected by climate-related risks irrespective of its size, business model and complexity. The multifaceted nature of climate-related risks requires that the regulated institution incorporate these risks into its established risk frameworks.
- ii. The nature, extent and materiality of climate-related financial risks warrants an integrated and holistic approach which focuses on the impact of these risks on the regulated institution's business model and strategy, including their capital and liquidity positions.
- iii. The regulated institution should consider climate-related financial risks under relevant financial risk categories such as credit, market, operational and liquidity risks.

b) Risk Management Function and Process

- i. The regulated institution should identify, measure, monitor, manage and report on financial risk exposures that arise from climate-related physical and transition risks. The regulated institution should ensure that these exposures to climate-related financial risks are embedded in the Enterprise Risk

¹ As defined in the Guidelines iro Climate-related Financial Risks Disclosure.

Management or similar framework. Accordingly, the regulated institution's risk appetite and risk management policies should include climate-related financial risks.

- ii. Climate-related financial risks can have wide-ranging impacts in terms of the sectors and geographies it affects. The regulated institution should consider potential transmission channels, the complexity of the impact on the financial sector and economy, uncertainty related to climate change, as well as potential interactions between physical and transition risks.
- iii. Regulated institutions should regularly carry out a comprehensive assessment of climate-related financial risks and set clear definitions and thresholds for materiality, bearing in mind a regulated institution's risk management framework would enable it to recognise all material risks with an integrated firm-wide perspective on risk.
- iv. As with other material risks, regulated institutions should develop appropriate key risk indicators for effective management of material climate-related financial risks that align with their regular monitoring and escalation arrangements.
- v. The risk management function is expected to develop appropriate quantitative and qualitative methods and metrics to be used in identifying, measuring, monitoring and managing its exposure to climate-related financial risks relative to its strategy and risk appetite. Where appropriate, the regulated institution should consider risk mitigation measures such as, but not limited to, establishing internal limits for the various types of climate-related financial risks to which they are exposed, such as in their credit, market, liquidity and operational risk profiles.
- vi. The risk management function is expected to provide the Board of Directors and relevant subcommittee(s) with reports on exposures to climate-related financial risks to enable the Board of Directors to discuss, challenge and make decisions relating to the regulated institution's management of climate-related financial risks, including setting risk appetite and monitoring compliance.
- vii. The regulated institution should adapt and implement appropriate training programmes, including for Board of Directors and Senior Management, to ensure that there is sufficient understanding of the impact of climate-related financial risks on the risk profiles of the regulated institution. The regulated institution should ensure that persons performing such function possess the necessary knowledge and skillset for effectively discharging their responsibilities.
- viii. Where climate-related financial risks are material, the risk management function should assess the impact of the risk on the regulated institution's resilience and consider the appropriateness of mitigation measures if avoidance of these risks is not possible.
- ix. The regulated institution may designate specific persons or unit to maintain primary responsibility for climate-related aspects and to ensure that climate-

related financial risks remain in scope and embedded into all relevant parts of the regulated institution's business.

- x. The regulated institution should have risk analysis capabilities for identifying relevant climate-related financial risks drivers that may materially impair their financial condition.

c) Compliance Function

- i. The compliance function's scope should include climate-related financial risks. It should systemically assess compliance with internal policies and procedures for these risks.
- ii. The compliance function should ensure that internal policies, procedures and controls are compliant with relevant regulatory and supervisory frameworks² as these relate to climate-related financial risks.
- iii. The compliance function should, on a continual basis, assess internal policies and procedures on climate-related financial risks.

d) Internal Audit Function

- i. The internal controls, risk management and compliance frameworks for climate-related financial risks should be reviewed by the internal audit function to ensure their adequacy and effectiveness. Where climate-related financial risks are material, the internal audit function should assess the impact of the risk on the regulated institution's resilience and consider the appropriateness of mitigation measures if avoidance of these risks is not possible.

5.3 Business Continuity

- a) Business continuity plans should reflect climate-related financial risks where such risks are deemed material.
- b) The regulated institution should ensure that business continuity plans account for physical risks that may disrupt the operations of the institution directly and indirectly through disruption of the operations of the outsourced service provider.
- c) Outsourcing material activities and functions is an inherent part of the activities of a regulated institution. The regulated institution should therefore ensure that there is continuity of the outsourced functions in the event of failure or disruption of an outsourcing service provider due to physical risk events.
- d) The regulated institution may consider utilising physical risk scenarios in assessing the climate-related financial risks associated with outsourced service providers.

² These will be issued after the three (3) year transitional period.

5.4 Internal Capital Adequacy Assessment Process (ICAAP)

This requirement applies to commercial banks only.

- a) Climate-related financial risks may have an impact on a commercial bank, regardless of its size, complexity, or business model. It is therefore imperative for a commercial bank to consider climate-related financial risks assessed as material that may negatively impact the commercial bank's capital position in its ICAAP. It is recognised that the incorporation of climate-related financial risks in the ICAAP will be iterative as the methodologies and data used to analyse these risks continue to mature.

5.5 Scenario Analysis

- a) Scenario analysis may serve numerous objectives and can be used as a supplementary risk and capital tool for risk identification, monitoring and assessment.
- b) Scenario analysis may help the regulated institution to understand the potential impact of climate-related financial risks on its business model and strategy, as well as assist in determining and quantifying the potential exposure to physical and transition risks.
- c) Whilst scenario analysis in respect of climate-related financial risks is evolving, the regulated institution is expected to align the objectives of these analyses with its risk appetite and risk management framework. This may relate to informing capital and liquidity planning or to their role as an integral element of sound risk management.
- d) The regulated institution should have written policies in place governing the scenario analysis methodologies and their objectives in the regulated institution's risk management framework as well as capital and liquidity planning process.
- e) Regulated institutions that have material climate-related financial risks exposure should use scenario analysis, and stress testing is optional.
- f) Regulated institutions should develop a forward-looking approach view of climate-related financial risks through scenario analysis.
- g) Regulated institutions should include results of forward-looking scenario analysis for a minimum of 3 years and ideally 5 years or longer when evaluating the regulated institution's capital adequacy. These should be based on sufficiently severe but plausible circumstances.
- h) Perform comprehensive and rigorous scenario analysis to identify possible events or market changes that may have serious adverse effects or significant impact on the regulated institution's capital and operations.

- i) Incorporate quantitative and qualitative techniques in scenario analysis to assess the impact on the regulated institution's exposure to specific events.
- j) Scenario analysis should be designed such that the output can be used for decision-making at the appropriate management and strategic levels.

6.0 Annex – Further Guidance

The Concept of Proportionality

The CBS' supervision mandate is forward-looking, risk-based and in a proportionate way, and as such, expects the same of regulated institutions when managing their risks.

Regulated institutions vary in terms of size, business model and complexity as well as in the extent to which they are or may be, exposed to climate-related financial risks. Accordingly, the CBS recommends that regulated institutions consider how the Guidelines can be best implemented given their business model and strategy. Not all the requirements in this Guidelines will be relevant for every regulated institution. In general, the CBS expects that a regulated institution that assesses climate-related financial risks to be material to its business model and strategy under the Guidelines applies more of the requirements than a regulated institution which assesses climate-related financial risks not be material. In assessing materiality of climate-related financial risks, regulated institutions, shall, amongst others, consider the various time horizon, that is, short, medium and long term. To note, in the context of outsourcing, the definition of materiality under the CBS' [Outsourcing Guidelines for Banks and Other Financial Institutions](#) shall apply.

Risk Drivers

Climate-related risks are drivers of other prudential risks. Below are examples of how climate-related risks can drive other prudential risks:

- *Credit Risk* – credit risk increases if climate-related risks drivers reduce borrowers' ability to repay and service their debt (income effect) or the ability of the regulated institution to fully recover the value of a loan in the event of default (wealth effect).

Market Risk – market risk may increase due to reduction in financial asset values, including the potential to trigger large, sudden and negative price adjustments where climate-related risks are not yet incorporated into prices. Climate-related financial risks could also lead to a breakdown in correlations between assets or a change in market liquidity for particular assets, undermining risk management assumptions.

- *Operational Risk* – operational risk may be driven by potential reputational damage resulting from changing market or consumer sentiment, interruption of business continuity or increasing legal and regulatory compliance risk associated with climate-sensitive investments and businesses.
- *Liquidity Risk* – liquidity risk may be impacted on the assets side and on the funding side. Liquidity risk may increase as regulated institutions' access to stable sources of funding could be reduced as market conditions change. Climate-related financial risks drivers may cause counterparties of regulated institutions to draw down deposits and credit lines.

Traditional Risk Types	Physical	Transition
	Examples of acute drivers: • Droughts • Floods • Storms • Heatwaves • Landslides • Wildfires Examples of chronic drivers: • Extreme weather variability • Ocean acidification • Increasing temperature • Sea level rise • Shift in rainfall pattern	Examples: • Policy, legislation and regulatory changes, such as those related to carbon pricing, other sustainable, green and blue energy transition measures • Technological changes with shift to sustainable, green and blue alternatives • Shifting market or customer sentiments with preferences for sustainable, green and blue alternatives
Credit	The ability to repay or exposure at risk may be impacted, for instance: • through a reduction in income following a climate event; • lower collateral valuations in real estate portfolios as a result of increased flood risk, landslides, damaged properties, lower yields in food crops.	Transition measures may trigger substantial adaptation costs and lower profitability, which may lead to an impact on the ability to repay as well as lower collateral values.
Market	Physical risk drivers may lead to a change in market sentiments and be the cause for sudden repricing or changes in volatility of asset prices.	Transition risk drivers may affect highly polluting sectors with high carbon emissions leading to a repricing of securities and derivatives related to such sectors.
Operational	Extreme weather events may cause damages to the properties of regulated institutions, such as branches and data centres, leading to disruptions in their operations.	Shifting market sentiments regarding climate issues may lead to reputation and liability risks for regulated institutions as a result of their financing of environmental controversial activities, projects, and/or business.

Other risks such as Liquidity and Business Model	Physical risk drivers may affect counterparties and have them withdraw their funds to repair damages caused by such events.	Transition risk drivers may affect the viability of some business lines and lead to strategic risk for specific business models. The liquidity of regulated institutions may be affected by abrupt repricing of securities due to transition risk drivers.
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