EASTERN CARIBBEAN CENTRAL BANK

PRUDENTIAL STANDARD ON CLIMATE-RELATED AND ENVIRONMENTAL RISKS FOR INSTITUTIONS LICENSED UNDER THE BANKING ACT, 2015

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PRUDENTIAL STANDARD ON CLIMATE-RELATED AND ENVIRONMENTAL RISKS FOR INSTITUTIONS LICENSED UNDER THE BANKING ACT, 2015

This Prudential Standard is issued by the Eastern Caribbean Central Bank (Central Bank), in exercise of the powers conferred on it by section 184 of the Banking (Amendment) Act, 2015[1] (hereinafter referred to as the Act).

1.0 Commencement

This Prudential Standard shall come into effect on the 1st day of March, 2024.

2.0 Interpretation

This section of the Prudential Standard employs the interpretation established in the Act. However, the following terms are defined for the purpose of this Prudential Standard:

i. ***"Climate-related risks"*** refers to the potential negative impacts of climate change on an institution, which includes physical and transition risks.

ii. ***"Confidentiality"*** refers to the assurance that information remains private to a licensed financial institution (LFI) and is not viewed or used by those unauthorised to do so.

iii. ***"Environmental Risk"*** relates primarily to the likelihood of an adverse consequence or threat of a negative effect on the operations of a LFI and its wider environment due to environmental degradation such as air pollution, water

[1]Banking (Amendment) Act, 2015 of Anguilla (No 6 of 2015);
Banking (Amendment) Act, 2015 of Antigua and Barbuda (No 10 of 2015);
Banking (Amendment) Act, 2015 of the Commonwealth of Dominica (No 4 of 2015);
Banking (Amendment) Act, 2015 of Grenada (No 20 of 2015);
Banking (Amendment) Act, 2015 of Montserrat (No 15 of 2015);
Banking (Amendment) Act, 2015 of Saint Christopher and Nevis (No 1 of 2015);
Banking Act, 2015 of Saint Lucia (No 3 of 2015); and
Banking (Amendment) Act, 2015 of Saint Vincent and the Grenadines (No 4 of 2015).

pollution and scarcity of fresh water, land contamination and desertification, biodiversity loss, and deforestation.

iv. ***"Governance"*** refers to the system by which an institution is directed and controlled in the interests of shareholders and other stakeholders. It involves a set of relationships between an institution's management, Board of Directors (board), shareholders, and other stakeholders. Governance provides the structure and processes through which the objectives of the institution are set, progress against performance is monitored, and results are evaluated.

v. ***"Management"*** refers to those positions an institution views as executive or senior management positions and that are generally separate from the board.

vi. ***"Material or Materiality"*** refers to the measurement of the importance of the relevant information about an item or person, which has the potential to influence significantly the decisions of lenders, investors, and other users of the financial information. Materiality can be related to the nature, size, complexity and implications of the information.

vii. ***"Material Activities"*** in relation to a LFI refers to:

   a. Activities or services of great significance that any weakness or failure in their delivery could have a significant effect on the institution's ability to continue as a going concern, and or meet its regulatory responsibilities;
   b. Key systems, activities or services without which, would inhibit an institution from delivering services to its customers;
   c. Any activity which would have a significant impact on an institution's risk management, and the management of risks relating to these activities; and
   d. Any other activities requiring authorisation from the Central Bank.

viii. ***"Physical Risks"*** are the economic costs and financial losses resulting from the increasing severity and frequency of:

a. Extreme climate change-related weather events (or extreme weather events) such as heatwaves, landslides, floods, wildfires and storms;
b. Longer-term gradual shifts of the climate such as changes in precipitation, extreme weather variability, ocean acidification, rising sea levels and average temperatures; and
c. Indirect effects of climate change such as loss of ecosystem services.

ix. ***"Risk Appetite"*** is a high-level determination of how much risk an institution is willing to accept, taking into account the risk/return attributes; it is often taken as a forward looking view of risk acceptance.

x. ***"Risk Management"*** refers to a set of processes that are carried out by an institution's board and management to support the achievement of the institution's objectives by addressing its risks and managing the combined potential impact of those risks.

xi. ***"Risk Tolerance"*** is a more specific determination of the level of variation an institution is willing to accept around business objectives that is often considered to be the amount of risk the institution is prepared to accept.

xii. **"Scenario Analysis"** refers to a process for identifying and assessing a potential range of outcomes of future events under conditions of uncertainty. In the case of climate change, it will include scenarios that allow an institution to explore and develop an understanding of how the physical and transition risks of climate change may impact its operations, strategies, and financial performance over time.

xiii. ***"Segregation of duties"*** refers to a basic internal control measure where no employee or group of employees should be in a position to both perpetrate and conceal errors or fraud in the normal course of their duties.

xiv. ***"Transaction"*** means a transfer of benefits, resources, obligations, or the provision of services, regardless of whether a price is charged.

xv. ***"Transition Risks"*** are the risks related to the process of adjustment towards a low-carbon economy. A low carbon economy is based on energy sources that produce low levels of greenhouse gas emissions.

3.0 Introduction

Climate change[2] refers to long-term shifts in temperatures and weather patterns. Climate-related and environmental risks are the risks that may arise from climate change or from efforts to mitigate climate change, their related impacts and economic and financial consequences. Climate-related and environmental risks comprise two main risk drivers: physical and transition risks that could impact the safety and soundness of financial institutions, and by extension, affect financial stability. The impact of physical and transition risks on financial institutions can affect other existing risk categories such as credit risk, market risk, liquidity risk, operational risk and reputational risk (**Reference Table 1**).

This Prudential Standard seeks to ensure that LFIs are better prepared to address risks related to climate change. It is consistent with the Basel Committee on Banking Supervision's (BCBS) consultative document entitled *the principles for the effective management and supervision of climate-related financial risks*[3] published in June 2022. The Central Bank realises that LFIs have different risk profiles and as such, the level of climate-related financial risks may differ. Hence, this Prudential Standard is wide-ranging and forward-looking.

The Central Bank anticipates that in implementing the principles outlined in this Standard, the board and senior management of the LFIs should be better positioned to exercise sound oversight to effectively identify, assess and monitor climate-related financial risks.

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[2]For more information on climate change, please visit this website: What Is Climate Change? | United Nations

[3] Principles for the effective management and supervision of climate-related financial risks (bis.org)

Table 1: The Effects of Physical and Transition Risks			
Risks Affected	**Physical**		**Transition**
	Climate-related	Environmental	Climate-related & Environmental
	▪ Extreme weather events ▪ Chronic weather patterns	▪ Water stress ▪ Resource scarcity ▪ Pollution	▪ Policy and regulation ▪ Technology ▪ Market buy-in
Credit risk	The probabilities of default due to exposures within sectors or geographies vulnerable to physical risk may be impacted, for example, through lower collateral valuations in real estate portfolios as a result of increased flood risk, and higher insurance coverage.		Energy efficiency standards may trigger substantial adaptation costs and lower corporate profitability, which may lead to a higher default, as well as lower collateral values.
Market risk	Severe physical events may lead to shifts in market expectations and could result in sudden repricing, higher volatility and losses in asset values on some markets.		Transition risk drivers may generate an abrupt repricing of securities and derivatives, for example, for products associated with industries affected by asset stranding.
Liquidity risk	Liquidity risk may be affected in the event of clients withdrawing money from their accounts in order to finance damage repairs and maintaining insurance coverage.		Transition risk drivers may affect the viability of some business lines and lead to strategic risk for specific business models if the necessary adaptation or diversification is not implemented. An abrupt repricing of securities, for instance due to asset stranding, may reduce the value of institutions' high quality liquid assets, thereby affecting liquidity buffers.
Operational risk	The institution's operations may be disrupted due to physical damage to its property, branches and data centres as a result of extreme weather events.		Changes in the economic landscape due to the transition to a low-carbon economy can affect the creditworthiness of the institutions' clients and industries. LFIs can face operational challenges in managing credit and market risks associated with these shifts.

4.0 Application

This Prudential Standard applies to all institutions licensed under the Act and must be read in conjunction with the credit risk standard, operational risk standard, and any other applicable prudential standards issued by the Central Bank, and other applicable legal requirements. LFIs found in violation of this Prudential Standard are subject to remedial actions specified in Sections 75 to 78 of the Act.

5.0 Prudential Standard Requirements

5.1 The Role of the Board of Directors

1. The board of directors (board) must consider material climate-related and environmental risks and opportunities when developing the institution's overall business strategy, business objectives and risk management framework, and to exercise effective oversight of climate-related and environmental risks.

2. The board has the ultimate responsibility for understanding the nature and the level of climate-related and environmental risks exposure taken by the institution. It is therefore binding upon the board to ensure climate-related and environmental risks become an integral part of the institution's overall risk management framework.

3. The board must ensure that the institution implements and develops a sound process for understanding the environment in which it operates, and for assessing the potential impact of climate-related and environmental risks drivers on the institution's business.

4. The board must encourage discussions between its members and/or senior management, as well as between senior management and staff, regarding the institution's climate-related and environmental risks exposure and management process.

5. The LFI's strategic plan and risk management framework should address material climate-related and environmental risks that could manifest over time, before the board grants approval. The management of material risk should be embedded in the relevant functions, units, policies and processes.

6. The board must ensure that the management and assessment of climate-related and environmental risks are included in the following documents:
   a. The annual budget;
   b. Procedures manuals;
   c. Risk management policies and framework;
   d. Business plan; and
   e. Strategic plan.

7. It is the responsibility of the board to set clear performance objectives for the LFI to manage climate-related risk.

8. In instances where the LFI decides to make climate-related investments such as the greening of the institution or investing in climate related instruments, such investments must be approved in line with the institution's current approval process.

9. A committee of the board must be responsible for the effective oversight of climate-related and environmental risks. The board must ensure that members of this committee and the LFI, build capacity on climate-related topics through training, workshops and external collaboration with expert institutions, inter alia. This will aid in the effective management of climate-related and environmental risks.

10. The board must approve appropriate policies, procedures and controls to be implemented by the LFI for the effective management of climate-related and environmental risks.

11. Roles and responsibilities associated with the identification and management of climate-related and environmental risks should be clearly assigned throughout the LFI's structure.

12. The board must ensure that the LFI has an effective internal control framework. The internal control framework must include a clear definition and assignment of climate-related and environmental risks, responsibilities and reporting lines for operational management, risk management and compliance, and internal audit. This will ensure a sound, comprehensive and effective identification, measurement, and mitigation of climate-related and environmental risks.

13. The board must ensure that the Internal Audit function of the institution reviews the robustness of the risk management framework in effectively managing climate-related and environmental risks. Where such reviews are outsourced (for example, to the external auditor), the LFI should ensure that the individuals conducting them are also competent and appropriately trained in the review of climate-related financial risks.

14. A preliminary report must be sent to the risk committee of the board informing of any climate-related and environmental issues within three (3) business days of occurrence. Thereafter, the report must be finalised and the board shall monitor and oversee progress made in addressing these issues.

5.2 The Role of Senior Management

1. Senior management is responsible for developing and implementing the institution's strategic plan in relation to climate-related and environmental risks. This also includes developing materiality criteria for approval by the board.

2. Senior management must build capacity to become equipped with the skills and experience to manage climate-related and environmental risks.

3. Senior management should assign clearly defined performance objectives and responsibilities for climate-related and environmental risks to management level positions or committees. The monitoring of these performance objectives must be done by senior management.

4. In cases where a new unit is formed to oversee climate-related and environmental risks, senior management must ensure that the new institutional structure is clear, and the unit's responsibilities and interaction with existing governance structures are clearly defined. Appropriate reporting lines must be established, which must include the processes by which management is informed about climate-related and environmental issues. Such a unit should be part of the institution's Risk and Compliance Department.

5. Senior Management must ensure that the board or a sub-committee receives regular and timely reports on material climate-related and environmental risks.

5.3 Risk Management

The identification, assessment and management of climate-related and environmental risks must be integrated into the institution's overall risk management strategy.

Key Performance Indicators (KPIs) and Key Risk Indicators (KRIs) are two main types of risk indicators that are relevant to climate-related and environmental risks. These indicators focus on measuring and assessing the impact of climate-related and environmental risks, as well as the institution's preparedness, and response to climate-related and environmental challenges. The risk indicators are used to monitor the main drivers associated with key risks identified by a LFI. Performance indicators are measurements which can provide insight into the operational process of a LFI, allowing the institution to identify weaknesses, failures and areas of potential loss.

LFIs should consider the following KPIs:

1. *Climate-related Investment Allocation* – this measures the percentage of investment directed towards climate-resilient projects, green technologies, or sustainable practices.
2. *Adaptation Strategies Implemented* – monitor the number or percentage of implemented measures which focused on climate adaptation such as flood defenses, heat-resistant infrastructure, or drought-tolerant crop varieties.
3. *Stakeholder Engagement* – measure the involvement and satisfaction levels of stakeholders in climate-related initiatives, reflecting the effectiveness of engagement efforts.
4. *Renewable Energy Adoption* – track the percentage increase in the use of renewable energy sources within the institution's operations.
5. *Carbon Emissions Reduction* – measure the reduction in the institution's carbon footprint over a specific period, reflecting efforts toward mitigating climate impact.

The following KRIs should also be taken into consideration by the LFIs:

1. *Regulatory Change Impact* – track and assess the potential impact of changing climate-related regulations on the institution's operations and compliance.
2. *Extreme Weather Events* – monitor the frequency and severity of weather-related incidents such as storms, floods or wildfires, which could pose a risk to operations or supply chains.
3. *Physical Asset Risk Exposure* – measure the level of exposure of physical assets to climate-related risks like sea-level rise, extreme temperatures, or natural disasters.

1. LFIs should identify, monitor and manage all climate-related and environmental risks that could affect their financial condition. The risk management strategy approved by the board must consider all material climate-related and environmental risks to which the institution is exposed, and determine a credible approach to managing such risks. Each LFI has the responsibility to ensure that its processes and procedures for the identification, measurement, assessment, monitoring and management of climate-related and environmental risks are clear and are reflected in the institution's risk management framework.

2. For the process of identifying and assessing climate-related and environmental risks, the risk management framework must be dynamic and must take into account existing regulatory requirements related to climate change such as limits on emissions, as well as other relevant factors.

3. LFIs should build capabilities in risk analysis by:
   a) Identifying relevant climate-related and environmental risk drivers that may materially impair their financial condition;
   b) Developing key risk indicators and metrics to quantify exposures to these risks; and
   c) Assessing the linkages between climate-related and environmental risks and traditional financial risk types such as credit and liquidity risks.

4. Appropriate key risk indicators must be established for the effective management of climate-related and environmental risks. The key indicators must be in line with regular monitoring arrangements. LFIs must consider and include mitigating measures in the risk management framework.

5. LFIs must include in their risk management framework, polices that set out specific limits on material climate-related and environmental risks.

6. The process used to assess the potential size and scope of identified climate-related and environmental risks must be included in the risk management framework.

7. The risk management framework must include definitions of risk terminology used, or references to existing risk classification frameworks used.

8. The decision process to mitigate, transfer, accept or control climate-related and environmental risks must be clear in the risk management framework. Additionally, the framework should include the process for prioritising climate-related and environmental risks including how materiality is determined. Institutions should develop materiality criteria for each category of risk (physical

and transition risks). The materiality should be based on the institution's profile including, but not limited to, its size and complexity.

9. In setting out the process for managing climate-related and environmental risks, other risks such as policy and legal risk, market risk and reputational risk should also be addressed. These risks are all climate-related and can have financial implications.

10. The institution must conduct annual comprehensive assessments, or more frequently if circumstances change, of climate-related and environmental risks.

11. LFIs must identify and quantify climate-related and environmental risks and incorporate them in their Internal Capital Adequacy Assessment Process. This includes material risks that may negatively affect the institution's capital position over relevant time periods.

5.4 Stress testing

1. LFIs must conduct scenario analysis for climate-related and environmental risks annually[4]. The scenario analysis, which includes stress testing, must reflect the institution's overall climate and environmental risk management objectives as approved by the board. Institutions should use stress testing to analyse the resilience of their business models and strategies based on a range of plausible climate-related outcomes, and to determine the impact of climate-related and environmental risk drivers on their overall risk profile.

2. The scenario analysis must capture relevant climate-related and environmental risks for the institution including physical and transition risks that are relevant to its business model, exposure profiles and business strategy. The analysis must cover outcomes across different transition paths, as well as paths where no

[4] Institutions will decide at what point in time the stress test will be conducted, however, institutions are encouraged to complete a climate-related stress test before the start of the hurricane season.

transition occurred. When conducting the analysis, the institution must consider the potential benefits and limitations of chosen scenarios and balance sheet assumptions.

3. The scenario analysis must include different timeframes such as short, medium and long term. This will enable the institution to target different risk management objectives.

4. LFIs must explain and document any material and relevant risks that were excluded from the scenario analysis. This must be included in the institution's report to the Central Bank.

5.5 Disclosure Requirements

1. In addition to existing disclosure requirements on material risks, LFIs are required to develop appropriate climate-related disclosures that are aligned with their approach to managing the associated risks.
2. LFIs should disclose in published financial statements, its approach to managing climate-related risks, in a manner that is clear and meaningful to its stakeholders.
3. The disclosures should incorporate the following:
    a. Governance, which includes the board's oversight and management's role in assessing and managing climate-related and environmental risks and opportunities;
    b. The strategy as it relates to the actual and potential impact of climate-related and environmental risks and opportunities on the LFI's businesses, strategy and financial planning, where such information is deemed material;
    c. Risk management in relation to identification, assessment and management of climate-related and environmental risks; and
    d. Metrics and targets, to assess and manage relevant climate-related and environmental risks and opportunities, where such information is deemed material.

5.6 Reporting requirements

1. LFIs must provide to the Central Bank a detailed report of any material impact of a climate-related or environmental risk event on their capital and liquidity no later than fourteen (14) days after the event has occurred.
2. The stress testing framework used by the institution and all scenario analyses conducted, must be sent to the Central Bank within thirty (30) days of completion.
3. The annual assessments must be reported to the Central Bank within sixty (60) days following the period to which it relates.