Network for Greening the Financial System

Technical document

Report on micro-prudential supervision of climate-related litigation risks

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NGFS

Central Banks and Supervisors
Network for Greening the Financial System

Foreword

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We are pleased to present this Report on micro-prudential supervision of climate-related litigation risks, *building on our 2021 NGFS publication,* Climate-related litigation: Raising awareness about a growing source of risk.

As the world advances on its journey towards net-zero emissions and increasingly contends with the physical risks of climate change, the actions or inaction of financial institutions will be subject to increasing legal scrutiny. In 2023, climate activist groups filed the first climate lawsuit against an international commercial bank for its role in financing the expansion of fossil fuels. There have also been more greenwashing-related complaints against financial institutions.

A companion report on Climate-related litigation: recent trends and developments *by the NGFS Experts' Network on Legal Issues also highlights the reality of climate-related litigation as a growing source of risk for financial institutions, and hence the need for heightened awareness of climate-related litigation risks by micro-prudential supervisors.*

This report builds on our past and recent work by examining the potential impact of climate-related litigation on financial institutions, reviewing current regulatory and supervisory practices, and setting out potential options of varying intensity for the micro-prudential supervision of climate-related litigation risk. The report also introduces preliminary principles for quantifying exposure to these risks.

The importance of climate-related litigation risk to financial institutions will increase in the coming years as the impact of climate change and economies' transition to net zero accelerate. We are hopeful that this report will advance the development of appropriate micro-prudential supervisory approaches.

We greatly appreciate the commitment and dedication of all workstream members who have contributed to this report, as well as the valuable engagement with industry participants and other stakeholders who have shared their expertise, insights and practices. A special thank you to the NGFS Secretariat for all their support and assistance over the past year.

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Executive summary

Micro-prudential supervision considerations of climate-related litigation risk is becoming ever more relevant as climate change related legal action increases globally. The NGFS Experts' Network on Legal Issues 2023 report *Climate-related litigation: recent trends and developments* ('2023 NGFS Report on climate-related litigation') provides an update on global climate-related litigation. This report will focus on the ensuing risks from a micro-prudential lens.

In the NGFS 2021 report, Climate-related litigation: Raising awareness about a growing source of risk ('2021 NGFS Report on climate-related litigation'), climate-related litigation risk is approached as a subset of traditional categories of physical and transition risk. However, climate-related litigation risk could differ from general litigation risk financial institutions face in various ways, therefore, understanding the risk drivers and transmission channels is important for supervisory oversight. Climate-related litigation cases could be non-linear with the potential to impact many different business types, including financial institutions. Additionally, rapid changes in treaties, statutes, and case laws could result in potential for large and unpredictable losses in legal cases.

International standard setting bodies' existing frameworks on litigation risk provides supervisors with guidance on climate-related litigation risk. The Basel Committee on Banking Supervision (BCBS) Framework and the Basel Core Principles (BCPs) can be applied to climate-related risk including litigation risk arising from climate-related change. The International Association of Insurance Supervisors (IAIS) also addresses general litigation risk in the Insurance Core Principles (ICPs) which can be applied in context of climate change litigation.

Based on a survey conducted by NGFS on its members, this report provides insight on the current supervisory landscape on climate-related litigation risk. In general, prudential supervisors are approaching the management of climate-related litigation risk within the context of traditional risk categories. Another targeted industry survey of financial institutions' current practices on managing climate-related litigation risk indicated that institutions are addressing these risks in their enterprise risk management framework.

To highlight specific climate-related litigation risk considerations, this report provides a toolbox of supervisory options that range from low to high intensity. Prudential regulators may consider how to assess climate-related litigation risk through exposure analysis at a jurisdictional and entity level. Supervisory options explored include awareness building exercises, risk mitigation and transfer considerations, establishing governance and risk management expectations to be assessed in prudential reviews, climate-related litigation disclosures, testing resilience through scenario analysis and regulatory capital considerations.

Preamble

The NGFS is committed to strengthening supervision of financial institutions' climate-related risks by fostering progress among NGFS members to incorporate climate-related and environmental risks within their supervisory frameworks and practices.

Climate-related litigation is an emerging and growing source of risks, and it is expected that the importance of these risks will continue to increase in the coming years. As such, the NGFS has sought to understand the financial risks for financial institutions associated with climate-related litigation.

This present report builds on the conclusions of the 2021 and 2023 NGFS Reports on climate-related litigation and complements them by examining the potential impacts of climate-related litigation on financial institutions, reviewing current regulatory and supervisory practices, and setting out potential options for the micro-prudential supervision of risks arising from the increase in climate-related litigation.

1. Risks associated with the rise in climate-related litigation

The NGFS defines **climate-related litigation** as cases before judicial and quasi-judicial bodies that involve material issues of climate change science, policy, or law, consistent with the approach taken by academic researchers in climate change law at the London School of Economics and Columbia University.[1]

As noted in the 2023 NGFS Report on climate-related litigation[2], this type of litigation has grown and evolved significantly in recent years. The report flags an increase in cases against corporate defendants such as fossil fuel and energy companies, as well as a growing trend of cases against corporates in other sectors such as agriculture, transport, plastics and, also, finance. Climate-related litigation against financial institutions has been showing a rising trend, with increases in claims of greenwashing, breaches of director's duties, and violation of corporate due diligence laws. To address these trends, this report on micro-prudential supervision provides a range of supervisory tools that can be applied to climate-related litigation risks of financial institutions arising from the private sector.

While the majority of cases continues to be brought against governments and public entities, the development of specific supervisory tools dealing with climate-related litigation risk from sovereigns is beyond the scope of this report. It is due to the inherent difficulties of predicting how climate litigation may create changes in different national legal frameworks, policies, and diplomatic settings. However, litigation against public entities may have indirect impacts on the financial sector as it may result in a public entity taking more ambitions climate actions and therefore increase transition risks.

Climate-related litigation as a risk driver

In this report, climate-related litigation risks ("CLR") are understood as any financial risks that impact a financial institution either directly or indirectly, arising from climate-related litigation. As discussed below, climate-related litigation risks can be understood as a sub-category of either physical or transition risks and can impact financial institutions' prudential risks through various transmission channels.

The potential impacts of climate-related litigation on the financial sector are still unclear but likely to be multifaceted and, as highlighted in 2015 by then Bank of England Governor Mark Carney, the risks arising from such litigation are "significant, uncertain and non-linear" and "will only increase as the science and evidence of climate change hardens"[3].

Understanding the risks arising from climate-related litigation is crucial for supervisors as the financial implications of such cases can be substantial

Climate-related litigation can lead to both direct and indirect costs for financial institutions. Litigation can result in direct financial costs such as damages and fines, legal and administrative fees, insurance premium costs, adaptation costs, compliance costs, and direct reputational costs. Possible indirect costs include insurance payouts[4] covering legal fees or settlements, credit losses or adverse business impacts if there is a deterioration of the borrower's creditworthiness or if a borrower's solvency is negatively impacted or has stranded assets, and reputational costs to the financial institution resulting from negative publicity.

As noted in both the 2021 and 2023 NGFS Reports on climate-related litigation, the outcome of climate-related litigation could also have an impact on a corporation's share price, its credit worthiness, and its financing costs. Increased financing costs could stem from higher cost of capital due to investors reducing their exposure or higher cost of funding due to credit rating downgrades. A recent study provides evidence that climate-related litigation filings or unfavourable court decisions had a negative impact on firm value, with the largest stock market impacts noted in cases filed against the

1 NGFS (2023); Setzer and Higham (2022). Broader definitions of climate-related litigation also appear in the literature (see Peel and Osofsky (2020)). The definition used here serves as general guide without precluding the occasional consideration of other notable cases.

2 The 2023 NGFS Report on climate-related litigation provides more details on the type of claims, defendants, categories of climate-related litigation, and examples of recent cases and actions.

3 Breaking the tragedy of the horizon – climate change and financial stability – speech by Mark Carney 2015.

4 Insurance payouts would be direct costs from insurer's perspective.

largest emitters operating in Energy, Utilities, and Materials (e.g., those corporates most responsible for global carbon and methane emissions, referred to as the 'Carbon Majors'[5]).

For the insurance sector, climate-related litigation could also lead to increases in premiums, increased use of exclusions, or the withdrawal of insurers from certain lines of business. While increased premiums resulting from pricing the risk posed by climate litigation into insurance policies may be appropriate from a micro-prudential perspective, there is a risk that future insurance coverage could become prohibitively expensive, coverage could be reduced or, in the extreme, not available at all.

Climate-related litigation risk as a sub-category of physical and transition risks

The 2020 NGFS Guide for Supervisors Integrating climate-related and environmental risks into prudential supervision noted that both the physical effects of climate change, as well as the transition to a low-carbon economy, are sources of financial risks. These physical and transition risks drive conventional prudential risks for both the banking and insurance sectors. In the 2020 guide, the NGFS recognizes that the potential financial impact of climate-related litigation can be considered as a subset of physical and transition risks and is referred to as "liability risk"[6]. This view is reiterated in the 2021 NGFS Report which notes that both physical and transition risks can be exacerbated by climate-related litigation.

While there is consensus around the definition of physical and transition risks, there is no commonly agreed definition of liability risk. Some authorities and standard setters account for liability risk within their definitions of physical or transition risks, while others have defined liability risk as an independent risk category[7]. Liability risk can also be viewed as a sub-set of litigation risk. This report uses the term litigation risk interchangeably with liability risk and, following NGFS established view, takes the position that **CLR** constitutes a subset of the traditional categories of physical and transition risks, as opposed to an independent risk category[8], as illustrated in Table 1.

Table 1 **CLR as a sub-category of physical risks and transition risks**[1]

Physical risks	Transition risks
Physical risks arise from acute climate-related events or chronic impacts of climate change.	Transition risks arise from the process of adjusting to a low-carbon economy, including changes in policy, regulation, technology, and consumer/market preferences.
Acute climate-related events (e.g., heatwaves, floods, hurricanes, wildfires) can impair or destroy asset values, lead to higher claims payments, and increase underwriting risks for insurers.	Transition risks can affect business profitability and household wealth, creating financial risks for investors and lenders, potentially including stranded assets or activities.
Chronic impacts of climate change (e.g., temperature and sea level rise, precipitation changes) can require significant investment in adaptation to prevent loss of revenue and capital erosion.	
↓	↓
CLR related to physical risks	**CLR related to transition risks**
Climate-related litigation targeting entities alleged to be (directly or indirectly) responsible for acute climate-related events or chronic impacts of climate change, and/or for failing to adapt to or mitigate them.	Climate-related litigation targeting entities for alleged failures to sufficiently reduce GHG emissions, adequately consider and/or disclose climate-related risks, breaches of fiduciary duties, greenwashing claims or misreading the transition (e.g., selling a carbon-intensive product with the knowledge it would become redundant in view of net-zero policies).

1 The definitions of physical and transition risk, and the related CLR, are based on NGFS (2021).

5 Sato M, Gostlow G, Higham C, Setzer J, Venmans F (2023) Impacts of climate litigation on firm value. Centre for Climate Change Economics and Policy Working Paper 421/Grantham Research Institute on Climate Change and the Environment Working Paper 397. London: London School of Economics and Political Science.

6 NGFS Guide for Supervisors: integrating climate-related and environmental risks into prudential supervision, 2020.

7 FSB, Supervisory and Regulatory Approaches to Climate-related Risks: Interim Report, 2022.

8 NGFS (2021). The Task Force on Climate-related Financial Disclosures (TCFD) also identifies litigation or legal risk as a subset of transition risk, while acknowledging that such litigation or legal risk can result from e.g., a failure to mitigate or adapt to climate change or insufficient disclosure of material financial risk (see TCFD (2017)).

Financial institutions can have both direct and indirect exposures to climate-related litigation risk

Financial institutions can be **directly exposed** to CLR as defendants in climate-related litigation or in regulatory investigations or enforcement proceedings. Potential grounds include the disclosure and management of climate-related risks, misleading marketing and greenwashing, breach of fiduciary duties, and corporate due diligence claims. Direct CLR can have an impact on the financial position and reputation of a financial institution.

Financial institutions may also have **indirect exposures** to defendants in climate-related litigation as well as broader assets classes, sectors and geographies that can lead to a revaluation following climate-related litigation. These can have impacts on the valuations of loans a financial institution has underwritten (i.e. the creditworthiness of the counterparties), collateral valuations, valuations of the investments it has made, and its reputation by association.

Insurers specifically are exposed to CLR on both the asset and liability sides of the balance sheet. An incorrect assessment can result in the risk being mispriced and under-provisioned, or an insurer going beyond its risk appetite, leading to prudential risks.

Climate-related litigation does not have to be successful for costs to materialise: a credible threat of litigation or even unsuccessful litigation may impact financial institutions.[9] In addition, litigation risks can materialise in advance of both physical and transition risks.[10]

While general litigation risk is typically captured within operational/compliance risk, climate-related litigation risk is a transversal risk that potentially impacts several risk categories. Moreover, it may be argued that climate-related litigation risk warrants special consideration given the potential for significant financial payouts, the rapidly evolving legal landscape, the growing body of scientific knowledge and development of attribution science, and the acceleration of climate change.

Box 1

Greenwashing, climate-related disclosures and CLR

Litigation against **climate-related greenwashing** is gaining pace. This type of litigation aims to hold defendants accountable for various forms of climate misinformation, such as misleading communication about climate commitments, product attributes, and other climate-related disclosures.

Recent legislative and regulatory developments demonstrate that litigants are not alone in paying increasing attention to sustainability claims and, more specifically, greenwashing of financial products. Increasingly, legislated mandatory disclosures are being developed in many jurisdictions.

For example, the European Union (EU) Sustainable Finance Disclosure Regulation (SFDR) lays down disclosure obligations for manufacturers of financial products and financial advisers towards end-investors. It requires the integration of sustainability risks as well as adverse impacts on sustainability factors at entity and product levels. The EU taxonomy for sustainable activities establishes a classification system guiding corporates and investors towards environmentally sustainable economic activities. The proposed Corporate Sustainability Due Diligence Directive (CSDDD) includes requirements for identifying, preventing, ending or mitigating adverse human rights and environmental impacts across value chains.

The U.S. Securities and Exchange Commission (SEC) created a Climate and ESG Task Force to proactively identify ESG-related misconduct. The Task Force focuses on material gaps or misstatements in issuers' disclosure of

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9 NGFS (2021); UNEP FI / MinterEllison (2021); Solana J (2020) Climate change litigation as financial risk.

10 FSB, Supervisory and Regulatory Approaches to Climate-related Risks: Interim Report, 2022, page 18.

climate risks, disclosure and compliance issues around ESG strategies and the evaluation and pursuit of tips, referrals and whistleblower complaints on ESG-related issues. The U.S. SEC published proposals to promote consistent, comparable and reliable information for investors concerning funds' and advisers' incorporation of ESG factors. The proposals call for more specific disclosures in fund prospectuses, annual reports, and adviser brochures. They have not yet been finalised and have faced opposition (see Box 2).

Laws governing prospectuses can also be a major source of greenwashing liability. U.S. securities laws and the EU Prospectus Regulation, for example, present a relatively low bar for claims. In addition to securities lawsuits, greenwashing cases can also be grounded on consumer protection and advertising laws, such as the EU Unfair Commercial Practices Directive and, in the future, the proposed Green Claims Directive.

These disclosure requirements may help define what is a credible climate related disclosure, which, in turn, could reduce entities risk of greenwashing if their disclosure is deemed credible. However, the proliferation of climate-related disclosure requirements and increasing expectations can also facilitate litigation against financial institutions if public disclosures are not accurate and supported by credible evidence.

Box 2

CLR from anti-ESG litigation

While the overwhelming majority of CLR takes the form of climate-aligned litigation (where plaintiffs seek to encourage mitigation or adaptation to climate change), an emerging trend is the growth of the anti-ESG movement, the rise of non-climate-aligned litigation, and concerns that climate collaboration among the financial sector (for example, joining a net-zero alliance) could be treated as an anti-trust violation.

In the U.S., some politicians and investors have used anti-trust and competition law arguments to challenge an allegedly ideological agenda, and these actions have had impacts internationally. Since the end of March 2023, the United Nations' Net Zero Insurance Alliance lost half of its members, some leaving due to ESG backlash and antitrust concerns and opting instead to pursue their climate ambitions individually.

This "anti-ESG" backlash has materialised in public declarations, reports, letters to corporates, withdrawal of state funds from asset managers with ESG priorities, as well as state laws and bills prohibiting the consideration of ESG factors in investment decisions. **Anti-ESG laws** could potentially become another source of CLR if financial institutions violate their provisions.

There are also cases of **non-climate-aligned litigation and arbitration**, in which an applicant challenges regulations, policies or other forms of climate-beneficial action, to delay or prevent climate action. These cases typically contest the use of regulatory powers, claim compensation for stranded assets or lament adverse impacts of climate action on the enjoyment of human rights.

While non-climate aligned litigation is existent[1] and financial institutions and supervisors should manage the associated risks, they should also consider that with physical climate events expected to increase in frequency and magnitude over time, the persistence of non-climate-aligned litigation may be strongly tested in the future.

1 Setzer J and Higham C (2023) Global Trends in Climate Change Litigation: 2023 Snapshot, p.g. 6.

2. Transmission of climate-related litigation risks into prudential risks

There is consensus among supervisory authorities and international standard-setters that climate-related physical and transition risk drivers manifest under existing categories of risk of the prudential framework. A similar approach is relevant for the assessment of CLR. The existing prudential framework for the supervision of banks and insurers provides an architecture for financial institutions to articulate the impacts of CLR.

The table below provides examples of how CLR can lead to increased prudential risks for both the banking and the insurance sectors.

Box 3

CLR as a driver of prudential risk categories[1]

Prudential Risk Category	What is the risk?[2]	Examples of how CLR can affect prudential risks
Credit	The risk that a borrower or counterparty will fail to meet its financial obligations in accordance with agreed terms.	Increased litigation costs can affect a corporate's creditworthiness by reducing its ability to repay and service the debt. Where a borrower is sued, banks face an increase in credit risks if the borrower is less able to service its debt repayments because of the financial costs related to the lawsuit.[3] Similarly, successful litigation against the borrower may impact the borrower's share price and may result in stranded assets (lowering credit worthiness) if the borrower must adapt its operations to comply with a court judgment or to avoid future litigation. CLR can also impact a company's supply chains, affecting its operations and profitability and, in turn, impacting its ability to repay its debt.[4] In the event of a counterparties default, banks may have limited ability to recover the full value of a loan if valuation of collateral has been reduced.
Operational	The risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events. It includes legal risk but excludes strategic and reputational risk.[5]	The financial costs following from direct exposure to climate-related litigation may vary from damages, fines[6] and various fees to costs for insurance premiums. Importantly, climate-related lawsuits could impact future operational decision making and lead to high adaptation and compliance costs as well.
Market	The risk of losses arising from adverse movements in market prices. It includes default risk, interest rate risk, credit spread risk, equity risk, foreign exchange risk and commodities risk.	Assets could experience significant price adjustments as CLR increases and is incorporated into market valuations (stemming from poorer market sentiments). As highlighted in earlier section, there is increasing evidence of climate litigation having impacts on firm values.[7] Increased market volatility would introduce uncertainty in financial institutions' risk management approaches.

…/…

1 Given that financial institutions can have both direct and indirect exposures to CLR, they can be transmitted to prudential risks via both ways. The list of examples below are not meant to be exhaustive. While credit risk and market risk are more likely to be the outcome of indirect exposures, other risks such as operational and insurance are more likely to be outcome of direct exposures. In other cases, it could also be a combination of both direct and indirect exposures, resulting in risks such as liquidity and reputational.

2 The definitions of the respective prudential risks are adapted and drawn mostly from the Basel Framework and the IAIS Glossary (for insurance-related risks).

3 BCBS, Climate-related risk drivers and their transmission channels, 2021.

4 European Banking Authority, The role of environmental risk in the prudential framework, 2 May 2022, pg. 67.

5 BCBS, Revisions to the Principles for the Sound Management of Operational Risk, 2021.

6 Fines could also stem from non-compliance with new or upcoming sustainability reporting or disclosure legislations and regulations.

7 Sato M, Gostlow G, Higham C, Setzer J, Venmans F (2023) Impacts of climate litigation on firm value. Centre for Climate Change Economics and Policy Working Paper 421/Grantham Research Institute on Climate Change and the Environment Working Paper 397. London: London School of Economics and Political Science.

Liquidity[8]	The risk of being unable to fund increases in assets and meet obligations as they come due, without incurring unacceptable losses.	CLR could impact a financial institution's liquidity and impair their ability to raise funds directly or indirectly. For banks, corporate clients may be forced to withdraw funds held with banks due to climate-related litigation. For insurers, CLR could impact liability policies with climate-related litigation coverage. An increase in climate-related litigation against directors could result in a higher number of claims on D&O[9] insurance, requiring potentially higher reserves to be held against policies to ensure adequate liquidity for the exposed insurer[10].
Insurance (including underwriting and claims reserving risks)	The risk of adverse change in the value of capital resources due to unexpected changes in the assumptions of pricing or reserving such as severity, frequency, trend, volatility, or level of occurrence rates.	Insurers may face CLR related insurance claims in respect of in-force policies, in which that risk may have not been fully priced for or allowed for in valuations of insurance liabilities. Higher than expected claims could lead to the need for higher reserves to be held against the policies and result in financial losses to the insurer. Going forward, insurers will have the ability to reflect CLR in their premium pricing as insurance policies with liability coverage are typically re-priced on an annual basis. However, their ability to price CLR adequately may be hindered by the significant uncertainty inherent in the cost of CLR related insurance claims.
Reputational	The risk arising from negative perception on the part of customers, counterparties, shareholders, investors, debtholders, market analysts, other relevant parties or regulators that can adversely affect the ability to maintain existing, or establish new, business relationships and continued access to sources of funding.	Negative publicity of direct and indirect climate related legal claims could cause losses to financial institutions. Banks may face an increase in indirect reputational risks for providing financing to borrowers such as heavy carbon emitters. Similarly, insurers may have an increased reputational risk due to underwriting or investing in sectors perceived as contributing to climate change.[11] Financial institutions face increased reputational risk due to the risk of greenwashing actions. Reputational risk may increase regardless of the outcome of the case. For example, the defendant may face reputational costs, which may translate into financial costs if there is an impact on the share price of the institution.

8 At present, there is little research on the direct impact of climate risk drivers more generally on banks' liquidity and, as such, determining the impact of climate-related litigation specifically is challenging. See also BCBS, Climate-related risk drivers and their transmission channels, April 2021.

9 Directors' & Officers' (D&O) policies insure individual directors (both executive and non-executive) and/or officers of a company against their liability for, and costs of defending, claims against them in that capacity.

10 Climate Financial Risk Forum, Scenario Analysis Working Group: Climate Litigation Risk Chapter, December 2022, pg. 91

11 IAIS, Application Paper on the Supervision of Climate-related Risks in the Insurance Sector, May 2021, pg. 10.

3. Overview of current frameworks on litigation risks and their implications for risks arising from climate-related litigation

International standard-setting bodies have traditionally considered litigation risk as a subset of operational risk. Standard-setting bodies are taking steps to evaluate whether current prudential regulatory frameworks sufficiently capture the risks posed by climate change, including by way of gap analyses of the current regulatory frameworks. The section below summarises the position of key international standard-setters with respect to the consideration of CLR in current frameworks:

a) Basel Committee on Banking Supervision (BCBS)

Litigation risk is captured in operational risk under the Basel Framework. The BCBS defines operational risk as the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events. **This definition includes legal risk** but excludes strategic and reputational risk.

The BCBS established a Task Force on Climate-related Financial Risks in 2020 to address climate-related financial risks within the banking sector. A BCBS review of the existing Basel Framework concluded that the Basel Core Principles (BCPs) and supervisory review process (SRP) were sufficiently broad and flexible to accommodate additional supervisory responses to climate related financial risks[11].

In discussing the transmission of climate-related risks, the BCBS notes that corporates, as well as banks, may also be exposed to an increasing legal and regulatory compliance risk as well as litigation and liability costs associated with climate-sensitive investments and businesses. Furthermore, climate-related lawsuits could target corporations, as well as banks, for past environmental conduct whilst seeking to direct future conduct[12].

In June 2022, the BCBS published *Principles for the effective management and supervision of climate-related financial risks*, which seek to improve banks' risk management and supervisors' practices in this area. More recently, in December 2022, the BCBS published FAQs to provide additional guidance clarifying how climate-related financial risk may be captured under existing Pillar 1 standards[13]. The guidance recognises that operational risk losses may be caused by litigation.

BCBS Principles sets forth that all material risks are fully integrated into banks' overall risk management processes for: governance, risk identification and assessment, monitoring and reporting, control and mitigation, business continuity and the role of disclosure. Furthermore, as set out in the BCBS standards, banks are required to adhere to minimum capital requirements (Pillar 1), hold additional capital buffers in accordance with individual size, risk profile and complexity (Pillar 2), and meet disclosure requirements (Pillar 3). Under Pillar 1, capital requirements must address credit risk, market risk, and operational risk[14] and this is complemented by Pillar 2 capital requirements which are intended to address risks that cannot be (fully) captured under Pillar 1, such as reputational risk[15]. The Pillar 3 disclosure framework aims to promote market discipline through regulatory disclosure requirements.

Based on the typical demarcation of Pillar 1 and Pillar 2 coverage, climate-related litigation causing credit, market and operational losses would be captured by Pillar 1 requirements, while litigation causing reputational and strategic losses would typically be captured by Pillar 2 requirements. International standard setters and supervisory authorities continue to discuss the necessary adjustments to Pillar 1 and Pillar 2 requirements to account for climate-related financial risks[16], and this is expected to also inform the consideration of CLR more specifically in the prudential framework.

11 Note that the BCBS is currently reviewing the BCPs, which may include changes related to climate-related financial risks. BCBS Press release June 6, 2023. A consultation paper on the proposed Pillar 3 framework is targeted by the end of 2023.

12 BCBS, Climate-related risk drivers and their transmission channels, April 2021.

13 BCBS, Frequently asked questions on climate related financial risks, FAQ 16, December 2022.

14 Prudential Regulation Authority, Climate-related financial risk management and the role of capital requirements, Box C, 28 October 2021.

15 Bank for International Settlements, Pillar 2 Framework – Executive Summary.

16 See FSB, Roadmap for Addressing Financial Risks from Climate Change, 2022 Progress Report, 14 July 2022.

The key issues identified with respect to fully integrating climate-related risks into Pillar 1 capital requirements are the lack of data and methodologies for quantifying climate-related risks to adjust prudential requirements accordingly (primarily because Pillar 1 modelling tends to be backward-looking rather than forward-looking) and divergence between the timeframe for climate-related risks to materialise and the time horizons of institutions' risk management (the latter being calibrated typically on an annual basis while the former can materialise in the short, medium and long term).[17] The principles-based nature of the Pillar 2 framework provides more flexibility at the national level to develop approaches to address climate-related financial risks as compared to the Pillar 1 framework. Supervisory actions under Pillar 2 could be based on scenario analysis and stress testing, which would involve impact estimates of both physical and transition risks[18], and this estimation should be expanded to account for material climate-related litigation risks (recognizing that such estimation would be challenging).

With respect to Pillar 3 disclosure requirements, the BCBS is currently developing prudential expectations for climate-related pillar 3 disclosures.

b) International Association of Insurance Supervisors (IAIS)

Litigation is one of many risks insurers may face and as such supervisors expect that insurers will incorporate it in their underwriting/pricing, reserving, risk management and capital requirements, as outlined in IAIS's Insurance Core Principles (ICPs)[19], which form the globally accepted framework for insurance supervision. The ICPs do not explicitly refer to litigation risks as ICPs are written to address the broad variety of risks related to insurance and its supervision.

The IAIS has concluded that the ICPs are sufficiently broad to cover climate risks. To clarify how supervisors and insurers should address climate-related risk, IAIS published an Application Paper in 2021 (the "IAIS Application Paper")[20] which incorporates advice, recommendations, and examples of good practice on how some ICPs may be applied in the context of climate change risks. IAIS is in the process of updating the IAIS Application Paper to provide further guidance on supervisory practices, including developing guidance related to various ICPS, such as market conduct related issues, some of which are directly linked to CLR.

In the IAIS Application Paper, CLR is contemplated as a separate category to physical and transition risks and is referred to as "liability risk." Liability risk is defined as the risk of climate-related claims under liability policies, as well as direct actions against insurers, for failing to manage climate risks.

17 NGFS, Guide for Supervisors: Integrating climate-related and environmental risks into prudential supervision, May 2020, pg 54; FSB, Roadmap for Addressing Financial Risks from Climate Change, 2022 Progress Report, 14 July 2022.

18 Financial Stability Institute, FSI Briefs No. 16: The regulatory response to climate risks.

19 IAIS, Insurance Core Principles and Common Framework for the Supervision of Internationally Active Insurance Groups, November 2019.

20 IAIS, Application Paper on the Supervision of Climate-related Risks in the Insurance Sector, May 2021.

Box 4

Sample questions for insurers on litigation risks

The IAIS Application Paper outlines questions and metrics which supervisors should ask insurers to understand the extent of their potential exposures to litigation risks:

i. Qualitative indicators:

- To what extent does the investment strategy include climate-related considerations, and does the insurer comply with its stated strategy?
- Has there been a legal judgement awarded in your jurisdiction relating to liability for climate change damages?
- Does your organisation consider that it may be directly or indirectly exposed to liability risks stemming from climate change, either now or into the future?[1]

ii. Quantitative indicators:

- Distribution of energy performance labels in insurers' commercial real estate and/or residential real estate portfolios;
- Carbon intensity ratings of various assets and proportion of assets that are exposed to carbon intensive industries;
- General insurance for coal, oil, and gas energy operations with exposure to climate-related litigation;
- Portfolio of relevant insurance liability covers such as for Directors and Officers;
- Professional liability insurance with exposure to climate-related litigation, such as architects' professional liability risks for a new commercial development that did not anticipate the increased risk of flooding.

1 IAIS, Application Paper on the Supervision of Climate-related Risks in the Insurance Sector, Box 1: Illustrative examples of relevant indicators, May 2021, pg. 13.

The IAIS Application Paper also outlines considerations which should be accounted for in supervisors' activities. This is because CLR can impact the business risk profile, investment activities, underwriting strategy and underwriting processes of insurers. When material, supervisors should expect insurers to identify the relevant litigation risks inherent in their business portfolios, assess the implications for their underwriting strategy and investment activities, and develop policies and procedures to integrate the management of these risks as part of their enterprise risk management (ERM) framework as well as the risk appetite statement. Increased monitoring may be required as certain non-life policies may face increased litigation risks because of evolving legal approaches and increased litigation linked to climate-related risks.

In addition, the compliance function should consider the liability and reputational risks stemming from climate change (e.g., from a failure to appropriately disclose information on climate-related exposure). Further, the Application Paper states that insurers should disclose the process for integrating climate-related risks and opportunities into underwriting processes across the business. Insurers may also describe the actions taken in response to CLR, such as new exclusion policies, an updated risk appetite statement and new underwriting targets. Insurers should disclose the process for undertaking scenario analysis, taking into consideration different climate-related scenarios (including litigation risk scenarios).

c) Financial Stability Board (FSB)

In 2022, the FSB published its final report *Supervisory and Regulatory Approaches to Climate-related Risks* to assist supervisory and regulatory authorities with their approaches to monitor, manage and mitigate risks arising from climate change and to promote a global approach to addressing climate-related financial risk.

In this final report[21], the FSB acknowledged that there are differing approaches towards contemplating liability risks (i.e., that some national authorities have accounted for liability risk within their definitions of either physical or transition risks, while others have established liability risk as a separate risk), however, it recognises that climate related liability risks might materialise independently from physical and transition risks. The FSB recommends having a clear definition of liability risk, whether as a separate definition or as a subset of physical and transition risk, to increase the consistency in how such risk is identified and assessed.

21 FSB, Supervisory and Regulatory Approaches to Climate-related Risks, 13 October 2022, pg. 22.

4. Overview of the supervisory landscape

This section provides an overview of surveyed members' approaches to the supervision of CLR. The NGFS undertook a survey of NGFS members in 2022 to understand current supervisory practices and plans, and to identify supervisory gaps. In total, the NGFS received 47 responses.

Overall, CLR is an emerging risk and, unsurprisingly, supervision of this risk is at an early stage of development. Many respondents have not yet specifically addressed CLR within their supervisory frameworks. However, most respondents do not differentiate between CLR and other general litigation risks and therefore are considering the impact of CLR under their existing prudential frameworks. The survey results highlight the need for additional supervisory tools and options to build on and enhance the current supervisory approach.

a) **Supervision of CLR is nascent and CLR is generally yet to be defined.** Most respondents have not set out an express definition of CLR in their supervisory frameworks, policies, or guidance. However, one respondent has expanded upon their definition of liability risk/litigation risk to be inclusive in the context of its Environmental, Social and Governance (ESG) risk framework. Another respondent indicates that while it does not provide its own definition, their supervisory guide on climate-related and environmental risks makes it clear that institutions are expected to evaluate the risk of a negative financial impact arising from future reputational damage, liability, and litigation.

b) **CLR is not treated differently from general litigation risk.** Generally, CLR is supervised under a member's existing prudential framework. This said, one respondent noted that CLR is treated differently as it is assessed in the broader context of other climate-related supervisory actions. Another respondent noted that their prudential regime continues to treat CLR with a monitoring approach, rather than requiring financial institutions to take specific supervisory actions given the risk is still emerging and material losses have not yet crystallized for many financial institutions in their jurisdiction.

c) **CLR is not defined as a separate risk category but is understood within the context of existing risks.** For the most part, CLR is considered a subset of operational and reputational risks and/or indirectly as market risk and credit risk. One respondent indicated that, to date, the risk has mainly been considered as a reputational risk since such litigation has generated negative publicity but has not had a substantial impact on operations. Another respondent classifies CLR as a standalone risk category while approximately 40% of respondents have yet to determine or articulate their approach.

d) **Formal supervision methodologies for CLR are not yet fully developed.** Two thirds of respondents indicated that they do not specifically consider direct or indirect exposures to CLR when supervising financial institutions. Among the respondents that do take CLR exposures into consideration, the type of claim identified by most respondents for both direct and indirect exposures is greenwashing.

Many respondents (73%) were unable to point to specific financial impacts of CLR that they are considering or tools to assess the risks, mostly because these risks are not yet addressed within their respective supervisory frameworks, or work to integrate them into their supervisory toolbox is ongoing.

e) **Need to develop specific supervisory tools, skills, and expertise to assess CLR.** Some respondents indicate that regulatory and supervisory expectations regarding the management of CLR are included in their jurisdiction's guide on climate-related and environmental risks. Others are in the process of developing potential guidance or tools to address this gap. For example, one respondent has recently published a set of good practices for financial institutions which provides examples on how to manage risks related to climate change, including litigation risks. A few (13%) respondents use existing tools such as scenario analysis to assess the risks and some respondents (13%) are developing potential tools or solutions to address this gap.

f) **Data and methodology challenges** make it difficult to quantify litigation losses or assign probability of occurrence. Most respondents (93%) do not quantify the impact of CLR on financial institutions. Several respondents are considering new regulatory developments to address this gap. Among respondents, there was only one that has undertaken an exercise to quantify the impact of CLR on financial institutions. This respondent conducted an exercise that tested firms' understanding and knowledge of the prudential risks surrounding climate-related litigation. In addition to qualitative information for banks, the exercise included a quantitative section for general insurers, testing their exposure to hypothetical climate-related litigation-related claims.

Most respondents (89%) do not collect specific data from financial institutions on climate-related litigation losses as part of broader operational loss reporting. However, several collect this information as part of more general requirements to report operational losses and four respondents are planning to start collecting climate specific data in the next year. Nevertheless, a great deal of work remains to be done to address the data and methodology challenge to address litigation losses.

g) **The risk of the insurance protection gap associated with CLR has not been widely considered.** Most of the respondents (93%) have not considered the potential for insurers to withdraw from covering CLR and the contingent impacts on other financial institutions. This could be particularly relevant for insurance products such as directors' and officers' insurance, product liability, and project finance. The remaining 7% of respondents have considered the impact of the withdrawal of insurers. The increasing climate-related litigation protection gap, due to the unavailability or unaffordability of such insurance, especially when the risks cannot be accurately calibrated, may impair banks' ability to mitigate the impact of physical risks on their customers as well as exacerbate banks' transition risks.

h) **There is limited specific insurance supervision associated with CLR.** Most respondents do not subject insurers to additional supervisory scrutiny for CLR, despite liability risks from underwriting activities. Only 4% of respondents ascertained potential differences in the supervision of CLR between the banking, insurance, asset management and pension fund sectors. While an insurer's indirect exposure to litigation risk via liability coverage is not a new risk for insurers, its direct exposure (e.g., the insurer itself being sued for not responsibly managing or disclosing its climate-related risk exposure) is relatively new. The indirect risk is well covered by existing insurance regulatory and supervisory frameworks (as outlined in the IAIS section above). Many supervisors have published expectations about how insurers should reflect climate change risks, highlighting the impact of climate on insurance liabilities arising from climate change related litigation.

Box 5

Emerging Industry Practices

The NGFS engaged with the Institute of International Finance (IIF) to conduct a targeted survey of a small, geographically diverse sample of banks' and insurers' current and emerging CLR practices. While practices vary across firms, this box summarizes the current approaches being taken by these firms.

Risk Management

Financial institutions surveyed have embedded CLR within their Enterprise Risk Management (ERM) frameworks. In some organizations an internal legal team is integrated within the risk policy and governance structure to provide advice on how to manage the risk. Some financial institutions surveyed have dedicated Environmental Social and Governance (ESG) committees, and address climate-related litigation risk within the context of strategic risk objectives.

Insurers take material climate-related litigation risk into consideration when reviewing underwriting strategies and controls. At least one of the insurers surveyed noted that they address these risks in their Own Risk Solvency Assessment (ORSA) reports, which are discussed with the Board.

At a client level, some banks have begun integrating CLR into their "Know Your Customer" (KYC) procedures during onboarding, with additional due diligence based on climate risk restrictions on business and the potential for high litigation risk. Clients are asked to complete risk control self-assessments and climate-related risks are integrated into risk registers.

Financial institutions are developing their approaches to CLR within broader efforts to enhance management of ESG risks, including addressing ESG in risk appetite statements, and in the case of insurers, outlining short and long-term requirements for their investment portfolio. Conditions may be placed on clients with heavy emissions and some types of projects, assets, or business models may be excluded (i.e., financing of new coal projects). Finally, one financial institution noted that internal targets for the organisation's decarbonisation will be set in the future.

Monitoring

Financial institutions surveyed are taking an array of approaches for monitoring CLR within their organizations, from ad-hoc reviews to dedicated teams of experts that monitor relevant developments. Some organizations with more mature approaches to CLR monitoring either utilized their internal legal counsel, external law firms specializing in climate-related litigation, and/or a specialized climate risk group. Written analysis of the organisation's exposures to CLR are shared systematically within the institution in the broader scope of the Enterprise Risk Management Framework.

At a client level, some financial institutions are monitoring CLR exposures through annual monitoring of clients financed emissions and decarbonization metrics. In the context of loan agreements, banks have utilized those metrics for the purposes of sustainability linked loans.

Mitigation

Financial institutions surveyed are applying various methods to mitigate CLR. These include regular review of internal policies, underwriting strategies and contracts; analysis of products and services to ensure alignment with internal decarbonization targets and legal and regulatory compliance; updates to internal stakeholders and knowledge building to raise risk awareness within the organization; and developing targets with policies aimed at increasing portfolio composition in green industries and practices.

Public facing mitigation methods noted include disclosing Key Performance Indicators (KPIs) in annual and comprehensive sustainability reports; compliance with relevant global principles and standards (such as the World Bank's Equator Principles[1] and the International Finance Corporation Performance Standards[2]); and utilizing auditing firms for annual assurance certificates for certain bond sustainability linked bonds.

Quantification

Financial institutions are exploring the use of scenario analysis to examine CLR; in the insurance sector, firms are considering the use of scenario analysis in liability insurance lines with assumptions that climate-related litigation may trigger claims. The solvency ratio is reviewed in the scenario analysis and stress testing to understand the materiality. While most financial institutions surveyed are at an early stage in efforts to quantify aspects of CLR, due to lack of data upon which to develop metrics, financial institutions are developing approaches in this area.

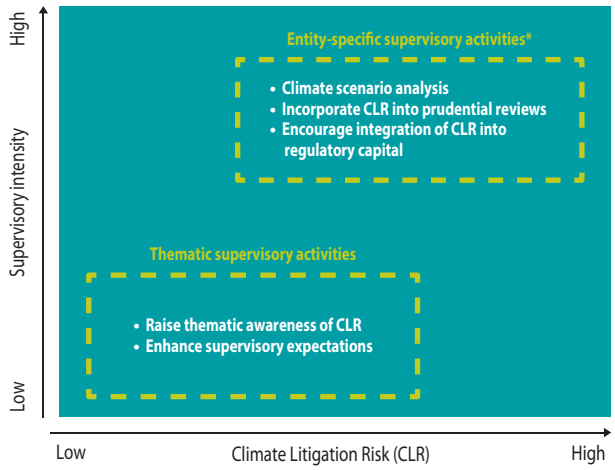
1 World Bank Equator Principles.

2 Performance Standards (ifc.org).

5. Possible supervisory approach

Given the nascent nature of CLR, this report suggests **supervisors adopt a risk-based approach[22] to better prioritise their supervisory activities**. This section provides prudential supervisors with a possible framework to assess the materiality of CLR at a jurisdictional and entity level. It also provides a non-exhaustive toolbox of supervisory approaches to prudently manage CLR for financial institutions.

Figure 1 **CLR Supervisory Toolbox**



**Additional considerations for insurer-specific supervisory activities (e.g. assessing insurers' control of policy wording, insurer CLR scenario analysis, wider contingent impacts of insurance coverage reduction or withdrawal).*

5.1 Risk assessment

Supervisors may wish to first conduct a risk assessment to gauge the materiality and nuances of CLR at a jurisdictional level, and, if appropriate, conduct further risk assessment at a regulated-entity level. The risk assessment, combined with the supervisors' risk-appetite, capacity, and capability, will determine the appropriate level of supervisory intensity.

a) **Jurisdictional level analysis. Supervisors can first assess the materiality of climate-related litigation in the operating jurisdictions of their regulated entities.** Supervisors could consider the following factors:

i. **Identify if the relevant jurisdiction is a CLR "hot-spot".** Entities operating in jurisdictions with a significant demonstrable history of CLR cases are operating in an elevated legal risk environment. Supervisors may also wish to examine the current trends and rate of new climate-related litigation cases in that jurisdiction, as a directional indicator of future potential legal or litigation risks.

ii. **Identify CLR trends in the jurisdiction.** Supervisors can review the known climate-related litigation cases in the jurisdiction and determine if there are any concerning or relevant thematic trends, such as specific industrial sectors being targeted, trends in legal nature of those cases, and the resulting outcomes.

iii. **Assess maturity and complexity of climate-related policy environment.** Jurisdictions with more developed climate policies will typically have a more complex compliance and regulatory environment, thereby increasing the regulatory burden and compliance and operational risk for entities. This includes policies such as climate-related disclosures, transition plans, taxonomies, and product standards. Some jurisdictions will face varying levels of policy maturity within the same national jurisdiction. The maturity of the policy environment can also be impacted by the political environment. Consideration should also be given to financial institutions that operate in many jurisdictions and must implement actions in a global context.

iv. **Assess the stability of the political environment.** Jurisdictions where the acceptance of climate science, or the prioritization of environmental outcomes is a contentious political issue, could create a volatile and complex legal environment. Entities may face litigation cases with conflicting objectives, seeking to increase or inhibit action to mitigate, or manage the impacts of climate change.

22 Where the concept of proportionality should be applied to ensure that applicable rules and supervisory practices are consistent with the financial institutions' systemic importance and risk profile.

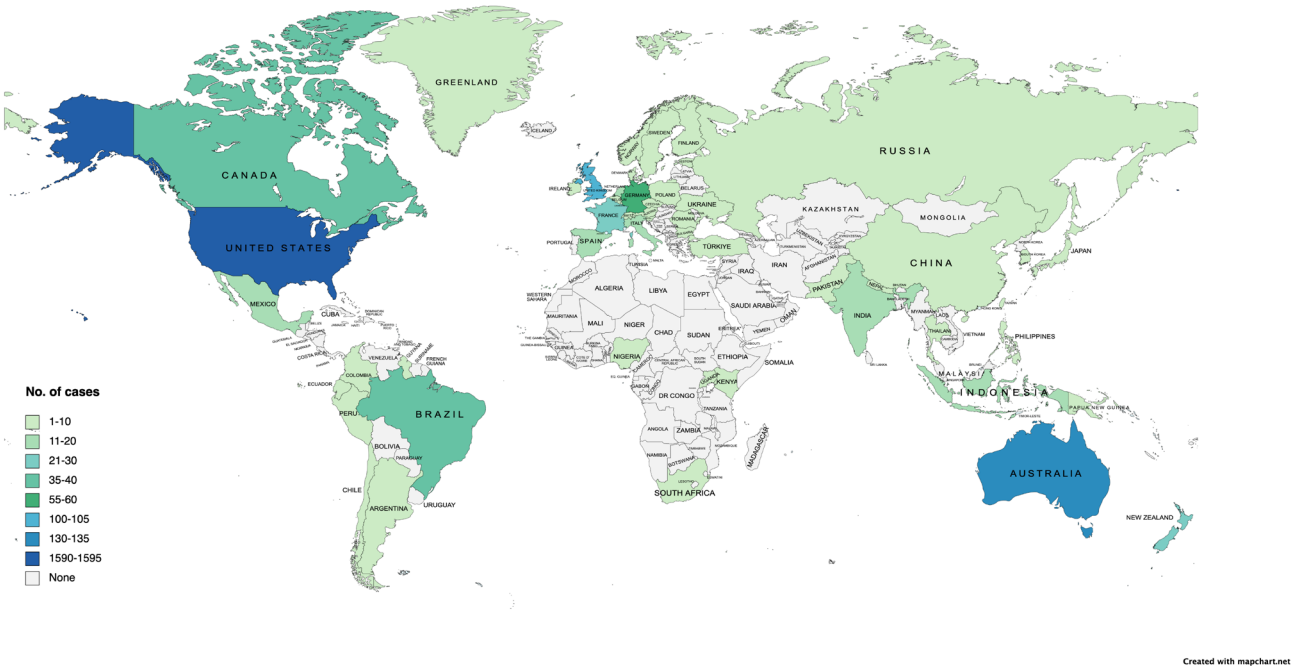
Such conditions make it more difficult to supervise CLR. Authorities in such jurisdictions may wish to consider how the political and legal environment may change given physical risk events are expected to increase in frequency and severity.

v. **Monitor climate-related litigation against financial institutions.** High-profile climate-related litigation cases against financial institutions, even in jurisdictions not directly relevant to the regulated entity, may test legal principles that could be applied in other jurisdictions. Supervisors may wish to assess the general legal environment of the jurisdiction and monitor such cases carefully[23].

To conduct a jurisdictional level analysis, supervisors may wish to consult well-known climate-related litigation databases such as those maintained by the Sabin Center, which provides data on pending and historic climate-related litigation cases, and the Grantham Institute, which provides data on climate-related laws, policies and UNFCCC submissions.

Figure 2 below provides a heatmap of global climate-related litigation cases up to May 2023[24]. Historically, climate-related litigation cases have been concentrated in the US, Australia, the UK, and the EU.

Figure 2 **Number of climate-related litigation cases around the world**



Note: Cumulative figures to 31 May 2023. This figure only includes cases filed before national courts or quasi-judicial bodies specific to a given country. The 118 cases filed before international or regional bodies, including the courts of the European Union, are not included.
Source: Authors based on Sabin Center databases. Created with mapchart.net.

23 A jurisdiction's legal framework might influence climate-related litigation risk; jurisdictions with lower barriers to litigation (i.e., legal systems that do not award adverse costs for losing litigation) are likely to have more climate litigation, as are jurisdictions with easier access to class-action suits.

24 Setzer J and Higham C (2023) Global Trends in Climate Change Litigation: 2023 Snapshot, p.g. 12.

Box 6

Examples of current good practices of CLR monitoring

Some authorities are already actively monitoring trends and developments relating to CLR, which supervisors may wish to draw on for guidance:

- As part of the **Bank of England's (BoE)** climate-related litigation monitoring function, the BoE's legal function monitors developments in global climate-related litigation of potential direct or indirect relevance for banks, and periodically brings these litigation trends to the attention of supervisors.
- Specific to greenwashing, the **European Supervisory Authorities** (the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA)) conducted a survey on greenwashing amongst supervisors and stakeholders to better understand which areas may become prone to greenwashing risks and help inform policy making and supervision. Progress reports on this topic, including a definition of greenwashing, were published, and submitted to the European Commission on 1 June 2023.[1]

1 EBA, "ESAs present common understanding of greenwashing and warn on related risks", June 2023.

b) **Entity-level exposure analysis. Supervisors may wish to increase their supervisory intensity and conduct CLR exposure analyses of their regulated entities**. The following approaches could help identify entities at risk to CLR, which could then justify more specific supervisory activities:

i. **Review existing climate-related litigation faced at an entity-level**. This is useful in identifying which entities (as well as sectors or peer groups) are currently exposed to CLR. Analysing the relevant legal actions can provide greater clarity on the nature, themes, and legal principles being tested, and provide insight on the existing CLR within a jurisdiction.

ii. **Identify entities with a large or concentrated portfolio exposure to high-emitting sectors.** Financial institutions with high exposure to sectors that have the most material accumulated GHG emissions across their value chain, are at greater risk of both direct and indirect CLR. Supervisors may wish to consider both on-balance and off-balance sheet exposures and activities.

   On-balance sheets exposures can arise from the provision of debt, equity, or insurance underwriting. Off-balance sheet exposures may be fee based, from activities such as facilitating access to capital markets, advisory, or operational services.

   Noting that while a sectoral level analysis allows a relatively straightforward and rapid assessment, it provides an imprecise analysis of an entity's specific historical (or forward looking) financed, underwritten, or facilitated finance emissions profile. The results should therefore only be used as a high-level indicator of risk. Supervisors may consider whether more in-depth, corporate or counterparty level exposure analysis is warranted, to improve the accuracy of the analysis.

iii. **Assess insurance coverage environment.** Financial institutions' CLR may be mitigated by their own insurance policy coverage, as well as the coverage of the companies in their portfolios. Supervisors may wish to engage with the insurance sector to thematically understand how corporate insurance policies cover different types of CLR. A high level of insurance coverage may insulate companies against CLR, while a low level could have the reverse effect. Authorities wishing to conduct a more in-depth analysis could consider using a CLR scenario analysis with insurers to explore the insurance coverage environment for CLR (refer to section 5.2(b)(ii)).

To effectively conduct CLR exposure analysis, supervisory authorities may need to enhance their data collection framework or activities.

5.2 Potential supervisory options

Utilising the CLR risk assessment outlined in section 5.1, supervisors could then consider the appropriate level of supervisory intensity to prudently manage CLR. Drawing on current good and emerging practices by supervisors and industry, the following section provides a non-exhaustive toolbox of supervisory options ranging from less resource intensive activities, such as thematic supervisory activities, to more intensive activities, such as climate risk scenario analysis.

a) Thematic supervisory activities. The following activities are typically high-level, lighter-touch supervisory options.

i. **Raise thematic awareness of CLR.** Supervisors may seek to raise the thematic awareness of CLR (including capacity development/building efforts) to prompt regulated entities to enhance their management of the risk. Incorporating CLR into publications, articles, and speeches is one potential thematic approach.

Box 7

Examples of supervisors including CLR in supervisory guidance

Supervisors may wish to draw on current good practices, with a number of authorities explicitly including CLR in supervisory guidance, most often in relation to operational risk and/or physical and transition risks.

- The **Hong Kong Monetary Authority's** ("HKMA") supervisory guidance states that operational and legal risk may increase, for example, due to "emerging legal cases related to climate change…"[1].
- The **Monetary Authority of Singapore** ("MAS") environmental risk management guidelines acknowledge as part of operational risk, that banks may face liability claims from parties who have suffered environmental-related losses and seek to recover those losses from banks they deem responsible. As part of an information paper for banks, MAS has also highlighted the rise in stakeholder expectations and the upward trend in climate-related cases being filed as contributing to potential legal risks.
- The climate and environmental risk management guide of **de Nederlandsche Bank** ("DNB"), published in March 2023, lists liability and legal fees as examples of operational risk, and specifically refers to the risk of litigation arising out of greenwashing or controversial investments.
- **The European Banking Authority's** ("EBA") report on management and supervision of ESG risks mentions litigation risks arising from climate-related and other environmental risks as a risk that could either qualify as physical or transition risk or fall into a separate risk category.

1 HKMA, Supervisory Policy Manual GS-1 Climate Risk Management, 30 December 2021, pg. 20.

ii. **Enhance supervisory expectations for financial institutions.** To promote a uniform understanding and effective management of CLR, supervisors could consider issuing or updating prudential expectations and guidance with respect to the following themes:
   - **Define CLR** to create a common understanding and facilitate easier communication across authorities and financial institutions.
   - **Set expectations for financial institutions to specifically capture CLR in their governance and risk management frameworks.** Whilst many financial institutions are already doing this, supervisors could consider setting formal expectations for them to incorporate CLR into their governance structure and risk management frameworks. This includes:
     a. Ensuring the Board, executives, and senior management are aware of the potential impact of CLR on their entity's risk profile, including potential reputational risks.
     b. Evaluating the metrics used to assess, track, or manage their actual or potential CLR. This can inform whether the risk is within appetite, whether appropriate provisioning is in place and whether financial institutions are taking appropriate mitigation steps.

c. Conducting a comparison between CLR risk management practices and non-climate related litigation risk management practices. Consider the robustness of those processes, and if CLR could be better managed by treating such risks consistently or differently.

- **Encourage financial institutions to produce credible climate-related disclosures to reduce direct CLR.** Such disclosures improve transparency and help meet stakeholder expectations, thereby reducing motivation for potential litigants to take legal action.

Box 8

Example: European Central Bank ("ECB") supervisory expectations related to CLR – 2020 Guide of climate-related and environmental risks

Supervisors may wish to draw on the current good practices exhibited by the ECB, which integrates CLR into their supervisory expectations in its 2020 Guide on climate-related and environmental risks ("Guide").[1]

The Guide describes how the ECB expects institutions to consider climate-related and environmental risks – as drivers of existing categories of risk – when formulating and implementing their business strategy and governance and risk management frameworks. With respect to climate-related litigation, the following expectations of the Guide are particularly relevant[2]:

- **Evaluate whether CLR can arise from business activities (Expectation 9.2):** institutions are expected to evaluate the extent to which the nature of the activities in which they are involved increases the risk of a negative financial impact arising from future reputational damage, liability and/or litigation.
- **Define tasks and responsibilities relating to climate risk (Expectation 5.5):** institutions are expected to define the tasks and responsibilities of the compliance function by ensuring that compliance risks stemming from climate-related and environmental risks are duly considered and effectively integrated in all relevant processes. In this expectation, it is also expressly noted that as rules and standards on sustainability may change over time, institutions may increasingly face compliance-related risks, such as liability, litigation and/or reputational risks, stemming from climate-related and environmental issues.
- **Conduct climate-related due diligence (Expectation 7.5):** institutions are expected to conduct a proper climate-related and environmental due diligence, both at the inception of a client relationship and on an ongoing basis.

The ECB assessed banks' alignment with the expectations set out in the Guide as part of the **ECB thematic review** conducted in 2022.[3] As a follow-up of this review, the ECB set institution-specific remediation timelines for achieving full alignment with the expectations by the end of 2024, providing details on intermediate steps.

The publication of the results of the thematic review was accompanied by a compendium of good practices[4] implemented by supervised banks. Examples of good practices with regards to managing CLR include conducting scenario analysis using loss estimates for potential remediation costs, legal costs, regulatory sanctions, client compensation, asset write-down and forgone revenue; and integrating CLR into the bank's PD rating system.

1 ECB, "Guide on climate-related and environmental risks", November 2020.

2 In addition, Expectation 13 on disclosure policies and procedures could also be relevant in the mitigation of CLR: "For the purposes of their regulatory disclosures, institutions are expected to publish meaningful information and key metrics on climate-related and environmental risks that they deem to be material, with due regard to the European Commission's Guidelines on non-financial reporting: Supplement on reporting climate-related information. For more information on disclosure, please also refer to below Box 9 – Assessing the credibility of an entity's climate-related disclosures.

3 ECB, "Walking the talk: Banks gearing up to manage risks from climate change and environmental degradation" (report) and ECB, "Good practices for climate-related and environmental risk management" (compendium of good practices), November 2022. This followed a first assessment published in November 2021: ECB, "The state of climate and environmental risk management in the banking sector: Report on the supervisory review of banks' approaches to manage climate and environmental risks", November 2021.

4 ECB, "Good practices for climate-related and environmental risk management" (compendium of good practices), November 2022.

b) Entity-specific supervisory activities. The following activities are typically entity-specific and more resource-intensive supervisory options. If a supervisor has identified specific regulated entities that are materially exposed to CLR, then they may wish to carry out the following targeted supervisory activities:

i. Incorporate CLR into prudential reviews. Supervisors may wish to engage directly with financial institutions on CLR to understand their alignment to supervisory guidance and expectations. This might take place as part of a broader prudential engagement with the entity and can involve a review of the following topics:

- how the entity is identifying both its direct and indirect exposures to CLR;
- whether the entity is holding protective CLR insurance policies;
- whether the entity has quantified the materiality of the exposure and assessed whether this is within the entity's risk appetite;
- assess how CLR is integrated into the entity's governance structure and the risk management framework (including overall strategy and metrics adopted), with clearly defined accountabilities; and
- assess the governance and risk management processes related to the entity's climate-related disclosures (see box below for guidance).

Box 9

Assessing the credibility of an entity's climate-related disclosures

Credible climate-related disclosures can act as a key mitigant to direct CLR by anticipating or meeting some of the key expectations of potential litigants, so long as those disclosures are made on a reasonable and defendable basis. The emergence of mandatory climate disclosure rules can provide uniformity on what constitutes as a credible disclosure[1]. However, that does raise the regulatory burden and compliance risks of entities.

Climate-related disclosures are typically supported by specific frameworks (at global, regional, and national level), and specific alignment approaches (including taxonomy-alignment or specific labels or criteria for sustainable financial products). These include the ISSB standard on sustainability and climate, current rules applying to financial market participants in the EU (*e.g.,* SFDR at entity-level, EU Taxonomy alignment disclosures at entity-level, NFRD duly revised by the CSRD, EBA's pillar 3 ESG) and the UK (*e.g.,* FCA's rules on enhancing climate-related disclosures by asset managers, life insurers and FCA-regulated pension providers; FCA's measures on investment product sustainability labels and restrictions on sustainability terms use), and greater emphasis put on disclosures of financed emissions by other global initiatives or frameworks.

Supervisors may wish to assess the governance, strategy, risk management, and metrics and targets related to an entity's climate-related disclosures to gain insight on the robustness of an entity's climate-related disclosure processes. Robust processes could support more credible climate-related disclosures, which in turn can help reduce exposure to CLR from greenwashing or green-hushing, and provide some evidence of corporate due diligence, or dispensation of directors' duties.

Assessing the governance, strategy, risk management and metrics and targets of entities can provide insight into other areas of supervisory interest beyond CLR. Areas of focus could include:

- Governance including board and/or senior management oversight.
- The control environment, including the operation of the three lines of defense.
- Control artefacts such as policies, procedures, training, reporting and metrics.
- Data management and quality assurance frameworks.

…/…

1 In 2017, the Taskforce on Climate-Related Financial Disclosures (TCFD) released its recommendations, which provided a voluntary framework for institutions to develop more effective climate-related financial disclosures. The TCFD produces annual progress reports analysing the current state of public disclosure practices. Going forward, it is expected that the ISSB's newly released standards will become the global baseline standard.

Noting that while assessing the credibility of an entity's climate-related disclosures is typically not within the traditional remit of prudential authorities, some supervisors may in the future wish to consider making a direct assessment themselves. In doing so, supervisors may seek to cooperate with other relevant authorities or regulators and could consider the following as key characteristics of high quality, comparable and reliable climate-related disclosures.

- The reporting framework is aligned to expected international or domestic standards;
- The reported metrics and data are scientific (disclosing or referencing the methodologies and criteria used), well-justified (ideally comparable to peer groups), and aligned to investor expectations;
- There is a clearly defined strategy and governance around the identification and management of climate-related financial risks; and
- The use of qualitative and quantitative assessment methods, including any estimates or assumptions, are science-based.

As part of their climate-related disclosures, entities may in the future be expected or required to produce sustainable transition plans. To help supervisors better understand the different approaches to supervising transition plans, please refer to the 2023 NGFS Stocktake Report[2] on transition plans.

2 Stocktake on Financial Institutions' Transition Plans and their Relevance to Micro-prudential Authorities (ngfs.net).

ii. **Climate scenario analysis.** Supervisors may wish to conduct their own qualitative and/or quantitative scenario analysis to gain insight on the prudential impact of indirect CLR on a regulated entity. This may involve analyzing the impact of climate-related litigation cases with stressed frequency, severity, and reduced levels of insurance coverage over the entity's portfolio and assessing their ability to withstand the risk and the overall prudential impact.

Box 10

Example: BoE Climate Biennial Exploratory Scenario ("CBES")

Supervisors may wish to draw on the **BoE**[1] 2021 Climate Biennial Exploratory Scenario ("CBES"), which assessed the extent of entities' understanding and knowledge of the prudential risks surrounding climate-related litigation. This included a quantitative scenario analysis for general insurers considering the potential financial impact of seven hypothetical legal cases, including mislabelling products and claims brought for funding carbon-intensive industries. The scenarios were intended to highlight the potential scale of CLR and to help regulated entities develop processes to monitor and manage the risk. Results of the exercise highlighted that many insurers had not assessed this issue before and that some insurance products, such as D&O insurance, might be more exposed to climate-related litigation than others.

Although the CBES scenario analysis on CLR was focused on general insurers, supervisors conducting their own exercise may consider expanding CLR scenario analyses to other financial institutions, such as banks.

1 BoE, "Results of the 2021 Climate Biennial Exploratory Scenario (CBES)", May 2022.

iii. **Encourage integration of CLR into pillar 2 of regulatory capital.** Financial institutions have a responsibility to determine their own capital adequacy through pillar 2 regimes (e.g., internal capital adequacy assessment processes (ICAAPs) and own risk and solvency assessments (ORSAs) and should be able to explain how they can ensure material CLR is appropriately capitalised through pillar 2/ORSA capital).

The evolving CLR landscape implies that past litigation and associated backward-looking historical losses of financial institutions may not be adequate indicators for estimating future climate-related litigations, or any material reputational risk impacts. As such, supervisors may wish to encourage regulated entities with material CLR to use forward-looking tools, such as scenario analysis and stress testing, for measuring CLR in their pillar 2 and/or ORSA capital regimes.

c) **Insurer-specific supervisory activities.** Insurers face additional CLR through their underwriting activities, which may warrant specific supervisory attention. Given CLR is an emerging risk class, there can be significant levels of uncertainty to an insurers' potential exposure to climate-related litigation insurance claims. Consequently, it is challenging for insurers to quantify, and therefore price the risk of CLR, in their potential liabilities. To ensure insurers are prudently managing and mitigating CLR, supervisors may consider the following supervisory activities:

- **Assess insurers' understanding and control of policy wording.** Policy wordings are often not sufficiently clear to determine the full extent to which climate-related litigation claims are covered. In some jurisdictions, the insurer may apply pollution exclusions or limitations. In other jurisdictions, insurers may exploit the failure of the policyholder in disclosing certain risks of their products to reduce potential liability or void the claim entirely. Because of this, policyholders may take legal action against the insurer to determine the insurance policy payout, introducing a second layer of legal uncertainty related to litigation claims.

Effective CLR risk management is supported by a detailed understanding and control over the policy wording of any liability insurance that the financial institution has underwritten, supported by reliable record-keeping. Some authorities have found many insurers have outsourced or may have incomplete records of their policy wordings.

- **Perform insurer CLR scenario analysis.** Particularly for insurers, CLR scenario analysis can provide valuable insight on an insurers' potential CLR exposure, and their ability to withstand and mitigate the risk. From the NGFS/IIF survey conducted with financial institutions (see earlier Box 5), it was found that some insurers have already developed their own CLR stress test scenarios with increased frequency and severity of climate-related litigation cases; these scenarios are utilized to better understand the risk from potential significant claims payouts from certain policies, such as Directors' and Officers' Liabilities.

In the absence of entity-led scenario analysis, supervisors may wish to conduct a regulator-led CLR scenario analysis, presenting a range of CLR scenarios to insurers, similar to the BoE's CBES (see earlier Box 10). In addition to utilizing scenario analysis at an insurer-level, supervisors could also use it to understand contingent impacts of insurance coverage reduction or withdrawals.

- **Explore wider contingent impacts of insurance coverage reduction or withdrawal.** There is a potential for the emergence of CLR to incentivize insurers to withdraw from certain sectors or limit liabilities to potential climate-litigation by changing policy wording. This incentive to reduce coverage or withdraw from certain sectors will be exacerbated if insurers are unable to obtain appropriate reinsurance coverage. This may result in a transfer of CLR from the insurance sector to other financial institutions. As part of wider risk assessment of climate-related litigation, supervisors may wish to monitor for any significant shifts in the risk appetite of the insurance industry and assess any resulting contagion risks.

6. Considerations going forward

CLR is continuing to develop as a trend, and there has been a high degree of variance by jurisdiction, political environment, and claim type and size. While there is a challenge of reliably estimating and predicting the evolution of this risk due to these variables, along with the fact that consistent and widely recognized precedents are slow to emerge, it is expected that the importance of this risk will continue to increase in the coming years. In addition, new climate action and disclosure expectations may result in exposure to additional CLR, such as the potential of not meeting emissions-reduction targets or, as most recently experienced, potential competition and antitrust violations. Notwithstanding, the NGFS has preliminarily explored some principles that could help for CLR quantification (refer to Annex for more information).

Legal "tipping points" could also contribute to significant non-linear increases in climate-related litigation. Public and market sentiment for climate-related litigation could change very quickly, driven by widespread acceptance of climate attribution science, catalyzed by the increasing frequency and severity of major weather-related events, updated laws, government policies and activities and the emergence of commercial impacts from transition risk-related product and sector dislocation. In addition, it should be noted that a backlash, that has also been observed when it comes to the implementation of other ESG initiatives, may expose financial institutions to litigation risk in various jurisdictions.

And finally, the scope of climate-related litigation could extend further to impacts on nature, biodiversity, and the environment.[25] Nature-related litigation risks could be more easily attributable to an entity than climate-related litigation, given nature degrading activities and impacts are often localised and more observable. With ongoing legislative developments, increasing disclosure expectations, and the evolving understanding of the inter-dependencies between climate change, nature, and biodiversity, the risks of climate-related litigation could be amplified.[26]

25 See also 2023 NGFS Report on climate-related litigation.

26 See also IAIS, Issues Paper on Insurance Sector Operational Resilience; 2023.

Annex: Principles for CLR Quantification – Loss and damage

Based on the results of the NGFS survey in 2022 regarding their approaches to supervising CLR, members broadly experienced challenges in quantifying the size and probability of the risk.

While there are many forms of CLR, NGFS members expressed particular interest in attempting to quantify potential litigation losses resulting from climate change loss and damage claims. Notwithstanding the high level of uncertainty and subjective assumptions required, the NGFS preliminarily explored some principles below as to how a supervisor could conceptually quantify the potential size of such claims, based on historically accumulated emissions. The below principles are not intended to be instructive nor comprehensive, but rather to provide a framework for supervisors' further discussion and exploration.

i. **Select the granularity of analysis.** Decide whether the analysis will be conducted at a sector-level, a sample of large entities, or an individual entity level. This will determine how the following principles are applied.

ii. **Estimate total potential climate-change driven loss and damage.** This estimation may consider how loss and damage outcomes could change under different climate change scenarios.

iii. **Allocate potential damages based on historical emissions contribution[27] to climate change.** Estimate potential damages based on the ratio of historic accumulated emissions per entity or sector to total cumulative global emissions. Those sectors or entities with the highest contributions are therefore more vulnerable to CLR.

iv. **Weight for the probability of damages being awarded in climate-related legal rulings.** Utilizing the jurisdictional analysis in section 5.1a, this probability could be influenced by a number of factors, including the following:
   - Existing precedents of successful climate litigation in the given jurisdiction.
   - The potential for legal acceptance of climate-attribution science in a jurisdiction.
   - Cross-border enforceability; for example, awarded damages being enforced against foreign corporates or sovereigns.
   - Any jurisdictional directional bias on climate-related litigation; for example, apply greater weighting to account for legal systems that are thematically favorable to climate-related litigation cases.
   - Socio-economic considerations, such as an "ability to pay": in other words, assess whether claimants are more or less likely to seek damages from corporates from low-income per capita countries.
   - Activity relevant weightings. For example, different weighting of damages for financing emissions compared to directly emitting greenhouse gases.

v. **Using the loss and damage projections, assess the potential exposure of financial institutions, both as direct and indirect CLR.** Utilizing an entity-level exposure analysis, consider impact of projected losses on credit, investment, underwriting, operational and other risks.

The above principles allocate future damages using historical emissions as a proxy for attribution of loss and damage and is therefore an imprecise projection. If reliable sector (or corporate) emissions pathways and scenarios become widely available, then potential damages could be more accurately estimated using a combination of historic emissions data, and future emissions pathways.

27 Note that this suggested emission-level approach could be appropriate only when the severity or frequency of CLR are commensurate with emission levels. However, this may not always be the case. For example, with respect to CLR from greenwashing, CLR may not be commensurate with the level of scope 1,2,3 emissions and the level of emissions might not always be a good proxy indicator.

Due to the significant uncertainty about how these risks may emerge, such estimates should be used for broad discussion only, rather than specific supervisory action. Several of the key factors driving uncertainty include but are not limited to:

- The unique characteristics of each country's own laws and legal frameworks.
- The inherent complexities of international legal action across different jurisdictions.
- The continued development and acceptance of scientific evidence, such as climate attribution science.[28]
- The emergence of new cases testing interpretations of law.
- The emergence of new laws, policies, and regulation.
- Emissions disclosures and data limitations.
- The emergence of increasing loss and damage from climate change, which if sufficiently material and/or frequent, could eventually trigger a rapid change in the above listed factors.

28 We refer to the field of science which quantifies the link between activities of a specific entity or state with the detrimental effects of anthropogenic climate change.

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