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Recommendations on Climate Risk and the Integrity of the Canadian Financial Sector

Context

Climate change is a growing threat to the financial system in Canada. Climate impacts have already begun to affect consumers, fair competition, affordability, and the overall stability of the financial sector, both internationally (Intergovernmental Panel on Climate Change, 2023) and domestically (Sawyer, 2022). As a signatory to the Paris Agreement, Canada has signed on to the goal of "making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development" (United Nations Framework Convention on Climate Change, 2015, p. 3)—including private financial flows.

Canada has a global reputation for sound financial regulation. However, without robust standards, independent oversight, and rigorous enforcement to align the financial sector with its climate commitments, this reputation hangs in the balance. Regulators and financial institutions must be empowered to align financial flows with climate objectives.

Reforming the financial system to align with the Paris Agreement is an essential tool for Canada to maintain its leadership in international climate policy, but it is also a critical step toward maintaining a prudentially informed, stable financial system that serves Canadians (Philipponnat, 2020). Climate-aligned financial policy is essential to safeguard Canadians' hard-earned savings and maintain Canada's competitiveness in a global market.

Threats to the Security and Integrity of the Canadian Financial Sector

Canada's financial system is at risk from climate change across multiple areas. Federally regulated financial institutions (FRFIs) and federally regulated pension plans (FRPPs) that are entrenched in high-emitting industries are both **exposed to climate risk and increasing climate risk**, each of which threatens to destabilize the Canadian financial system (Carney, 2015; Environmental Defence et al., 2022) Physical and financial risk take some of the following forms:

Physical Climate Risk to Collateral: As climate hazards multiply, both through slow-onset events like temperature changes and extreme weather events, the physical collateral backing banks' credit exposures will be increasingly compromised. The European Central Bank (2021) estimates that only 35% of climate losses are sufficiently insured in the EU. The Insurance Bureau of Canada reported that insurance costs have continued to rise significantly, with severe weather causing approximately CAD 3.1 billion in insured damage last year ("Extreme Weather Risk," 2023).

Recent studies have raised serious concerns about the cost of delaying or refusing to take action against climate change. The scale of damage (and the diminishing capacity of the insurance industry to cover it) will cause significant losses to banks, insurers, and Canadians across the board if unaddressed. For example, recent wildfires in Canada caused unprecedented Q3 losses of CAD 570 million for Intact Financial in 2023 (Dubey, 2023). At the international scale, the damages to the global economy could reach USD 178 trillion over the next 50 years (Deloitte, 2022); in Canada, the cost of inaction could reach CAD 5.5 trillion by the end of this century (Cleary & Wilcott, 2022).

Transition Risks: The global transition from fossil fuels to renewables is accelerating, with recent International Energy Agency reports estimating that oil markets will peak by 2030 (2023). As the transition continues, institutions that are heavily invested in carbon-intensive assets become vulnerable to exposure from asset repricing. If markets reprice the financial risk associated with climate change due to ongoing climate impacts, rapid growth in green finance, and subsequent environmental, social, and corporate governance investing, banks could face severe losses from these investments.

Canada is particularly vulnerable to transition risks due to the importance of carbon-intensive investments. Major banks – the Royal Bank of Canada, Scotiabank, Toronto-Dominion, the Bank of Montreal, and CIBC—provided financing of over USD 100 billion to fossil fuel companies in 2022

(Banktrack et al., 2023). Canadian institutional investors, including Canada's "Maple Eight" pensions, are significantly exposed to long-term risks. The Bank of Canada and the Office of the Superintendent for Financial Institutions (OSFI) estimate that in a delayed climate action scenario market repricing could pull forward transition costs in such a way that national GDP would deviate up to 10% below baseline by 2050 (Bank of Canada & OSFI, 2022).

Stranded Asset Risks: As markets reprice rapidly during a global energy transition, firms with significant investments in fossil fuels infrastructure leave themselves exposed to the risk of stranded assets. One estimate suggests that Canada may have as much as USD 100 billion in physical stranded fossil fuel assets as a result of the global low-carbon transition (Semieniuk et al., 2022). The costs of those stranded assets will be borne by project investors.

Environmental Risks: Analyses of future energy mixes make it clear that neither Canada nor the world has any room remaining for fossil fuel expansion if they are to meet Paris Agreement targets (International Energy Agency, 2023). Further investment by banks into fossil fuels keeps funding away from necessary investments in renewables, allowing emissions to rise and further destabilize the financial system (Philipponnat, 2020).

Underpricing Risks Due to Modelling Complexities: Canada's FRFIs and FRPPs undertake strenuous modelling exercises to mitigate global risks. That said, the unprecedented and nonlinear nature of climate risks makes them extremely difficult to integrate into current financial models. Models' assumptions are outdated compared to climate science, considering that they rely on previous high-stress events and do not take into account nonlinear and cascading shocks from climate change (Bank of Canada & OSFI, 2022; Stern et al., 2021; Trust et al., 2023). They are also under-equipped to consider climate-related exposures: due to a lack of fine-grained asset data, models cannot consider the latent risks of capital stock not built to withstand business-as-usual climate scenarios (Condon, 2021; Trust et al., 2023). Finally, current models can demonstrate misaligned incentives, such as a lack of consideration for intergenerational impacts (Stern et al., 2021). These limitations in current modelling practices result in underpricing risks, making the dangers of climate change to the stability of Canada's financial system that much more severe.

Taken as a whole, the risks outlined above are compounding, nonlinear, and significantly underpriced by current regulators and private actors. Shifting Canada's legal and policy frameworks toward green financial regulation is an unparalleled opportunity to send strong guidance to both FRFIs and FRPPs. The Ministry of Finance must implement comprehensive adaptations to policy and legislative frameworks to protect consumers and uphold financial integrity in Canada.

Adapting Policy and Law to Protect Consumers and Uphold Financial Integrity

While the current standard of voluntary disclosure of climate risks has enabled further transparency of FRFIs' assets in Canada and abroad, assessments show that it has failed to prevent greenwashing and stop the accumulation of climate risk (Duarte, 2022; Macleod & Cutinha, 2023). The current financial climate requires not only voluntary disclosure, but also sector-wide regulation and guidance that can ensure prudential investment decisions. This need was reflected in the Minister's 2021 mandate letter, calling for Finance to "work with provinces and territories to move toward mandatory climate-related financial disclosures based on the Task Force on Climate-related Financial Disclosures framework" (Prime Minister's Office, 2021). These signals stand on the shoulders of global momentum created by the UK Transition Plan Taskforce, whose framework complements and builds on the International Sustainability Standards Board and draws on the Glasgow Financial Alliance for Net Zero framework for transition planning (Transition Plan Taskforce, 2023).

We recommend three approaches to ensuring consumer protection and upholding financial integrity:

- **regulate banks beyond voluntary disclosure to require mandatory climate transition plans.** Regulation should require FRFIs and FRPPs to publish, implement, and annually report on scientifically credible climate transition plans that outline detailed steps to transition from emissions-intensive investments toward stable sectors that bring investments in line with a Paris Agreement-aligned pathway. The Ministry of Finance should empower OSFI, whose mandate is to ensure stability at the institutional level, to review these plans, and

approve them or require improvements, as necessary. It should similarly entrust Innovation, Science and Economic Development Canada to use the Canada Business Corporations Act as the enabling legislation for mandatory transition plans in the private corporate sector.

Further details on climate transition plans are elaborated in the *Roadmap to a Sustainable Financial System* (Environmental Defence et al., 2022, attached).

- **send clear signals about the fiduciary duties of FRFIs and FRPPs.** To set the standard for climate mitigation and transition plans, the Minister of Finance should publish an annual report on climate risks and opportunities for the federal public administration that sets the standard on climate risks and opportunities. Current requirements include climate risk disclosure; transition planning is an essential next step. The Ministry should also clarify in guidance and legislation that the fiduciary duties of FRFIs and FRPPs include assessment, disclosure, and **positive action** toward managing climate risks and opportunities. It should make clear that existing fiduciary duties include mitigating climate risk.

  With revenues up to 7% of GDP, large Crown corporations should also be required to prepare climate transition plans due to their size and importance in Canada's economy, (Treasury Board of Canada, 2023).

- **empower regulators and investors by establishing a Green and Transition Finance Taxonomy.** Greenwashing is a significant challenge in the Canadian financial sector, distorting market signals away from essential market transitions toward sustainable investments. By enabling the Sustainable Finance Action Council to produce a Green Taxonomy by fall 2024 at the latest, the Ministry of Finance can ensure that Canadian consumers and investors can make appropriate decisions with regard to Paris-compatible investments.

  Enshrining the Taxonomy under regulations under the Competition Act will ensure its linking to disclosure requirements for corporations, Crown corporations, financial institutions, and pension plans through regulations under the Canada Business Corporations Act, the Financial Administration Act, the Pension Benefits Standards Act, and guidelines set by OSFI. Linking the Taxonomy to advertising laws under the Competition Bureau will enable the government to eliminate greenwashing and its concomitant market distortions.

  Aligning the Taxonomy with the goals of the Paris Agreement to limit global warming to 1.5°C and basing its guidelines on scientifically credible information is essential to ensuring its success. As such, it should not give labels of green or transition finance to unproven and as-yet unscalable technologies, such as carbon capture, utilization, and sequestration in the oil and gas sector (Cameron & Carter, 2023). Nor should it allow for investments in natural gas for infrastructure expansion or blue hydrogen generation, which are incompatible with net-zero scenarios (Muttitt et al., 2021). To align with 1.5°C-aligned global energy scenarios, the Taxonomy must exclude natural gas and any coal, oil, or gas expansion from the transition category.

  In alignment with the Sustainable Finance Action Council and its Chair's recommendation, we recommend that the Taxonomy Council should include at least one voting seat for civil society to provide unbiased expertise to complete the details of a Taxonomy.

  We further recommend that the Ministry empower the public to tackle greenwashing by publishing guidance for industry and advertisers.

Changing the Financial Sector's Legislative Framework to Serve Canada's Interests

Canada has made progress in aligning its financial legislative framework with net-zero objectives. The Canadian Net Zero Emissions Accountability Act (CNZEAA) requires the Minister of Finance to report annually on the financial risks and opportunities related to climate change (Canadian Net-Zero Emissions Accountability Act, 2021). In March 2023, the OSFI released a Guideline on Climate Risk

Management detailing its expectations related to climate-related financial disclosures (OSFI, 2023). Beyond these strong signals, however, there remain major legislative gaps to fill to ensure robust guidelines for FRFIs and FRPPs. We recommend the following steps to ensure that all aspects of Canada's private financial flows align with Canada's Paris Agreement commitments:

- **updating Canada's financial legislative framework to establish how to align with net-zero.** Opportunities for improvement include the following:
  - Adopting regulations under CNZEAA that prescribe minimum content of scientifically credible climate transition plans for the federal public administration (see above).
  - Adopting regulations under the Bank Act, Trust and Loan Companies Act, the Insurance Companies Act, and the Cooperative Credit Associations Act outlining the minimum content of climate transition plans and requiring their inclusion in annual financial statements.
  - Adopting regulations under the Pension Benefits Standards Act outlining the minimum contents of climate plans and requiring their inclusion in annual regulatory returns.

- **reforming the Export Development Act and Business Development Bank of Canada Act to ensure no new fossil fuel finance.** Currently, most domestic public finance toward fossil fuels coming from Canada flows through Export Development Canada (EDC) (Oil Change International, n.d.). While EDC has ended new direct financing to international fossil fuel companies, it is continuing to provide general corporate loans and other financial support to Canadian fossil fuel companies. (EDC, 2022). As of June 30, 2023, EDC had facilitated business in the oil and gas sector to the order of CAD 4.343 billion (OCI, 2023). For EDC to align with the goals of the Paris Agreement, it must immediately end support for any projects or companies engaged in new fossil fuel production or expansion, including through the Canada Account.

- **requiring financial Crown corporations and departments to develop, publish, and report on climate transition plans.** These plans should be subject to review and approval by the Minister of Finance, with input from the Net-Zero Advisory Board. This will help the Minister of Finance fulfill the obligation in CNZEAA, Section 23, to report annually on the financial risks and opportunities related to climate change by providing high-quality information. It will also move Crown corporations to align with Canada's climate commitments and allow individuals to better understand the progress the federal government is making to reach net-zero. A cabinet directive could be issued to require financial Crown corporations to include credible climate transition plans in their annual corporate report and the Financial Administration Act be amended to include a requirement for such plans.

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