FINANSINSPEKTIONEN

Sustainability Report 2021 – the climate in focus

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Foreword

In 2015, the Swedish Parliament decided on a new goal for the financial sector: the financial system must contribute to sustainable development. Actors in financial markets must take environmental, social and corporate governance issues into account when conducting business. In many ways, this sustainability perspective has a natural connection to the factors that financial firms need to consider to be able to assess the risk associated with their business dealings – regardless of whether these are related to lending, insurance, investments, etc.

Addressing climate change is a central part of the sustainability work in society, and it will entail major changes for many businesses. Both climate change and measures to transition to climate neutrality introduce risks, and potentially major risks, for individual businesses as well as the economy as a whole, and thus also for the financial system. Many businesses are also marketing themselves and their products as green. This is a welcome development, but it also comes with risks for consumer protection.

FI has been tasked with promoting a stable financial system that contributes to sustainable development and a high level of consumer protection. Therefore, we need to make sure that the financial system manages climate risks and contributes to the transition. In order to do this, financial firms need to be able to identify which activities will be impacted positively – and negatively – by a green structural transformation. Then, they can also contribute to the financing of investments to transition to climate neutrality and meet the demands of climate-savvy customers.

New EU regulations entering into force this year will have a major impact on the financial market's role in the area of sustainability. The EU regulation on sustainability-related disclosures (the Disclosure Regulation) tightens requirements on, for example, fund management companies and insurance companies to report sustainability-related information on businesses for which they provide different forms of financing. The EU taxonomy (the Taxonomy) for sustainable investments provides detailed rules for assessing whether an activity can be categorised as environmentally sustainable. Similar requirements are expected for banks' lending activities, and FI encourages banks to be proactive and already now align with requirements that can be expected in coming regulation.

The new regulatory framework has been developed in a short time and is ambitious in scope. Global problems require global solutions, and it is positive that the EU, which represents one-sixth of both the world economy and global emissions, is at the forefront. But the rules are complex, and their implementation raises challenges for financial market participants that are affected, and have the responsibility for finding forms through which to apply the Disclosure Regulation and the Taxonomy. FI is helping to facilitate this work by pursuing a dialogue with both individual firms and industry representatives to answer questions and develop best practices.

As a supervisory authority, FI can help to facilitate the transition and remove obstacles. One of our most important tasks right now is related to firms' sustainability reporting. Stricter reporting requirements for firms in general are a condition for financial firms as intermediaries to be able to live up to the high demands on transparency of financial exposures. It needs to be easier for investors and other stakeholders to understand and compare information about a firm's climate exposures and work to transition. FI has therefore taken an active role in an ongoing international cooperation to develop a global standard based on the TCFD recommendations.[1] We are also pushing for more firms to already now start reporting in accordance with these recommendations.

This report also outlines a number of other prioritised activities in the area of sustainability. As part of the assignment that FI has had during the year, we investigated to what extent financial firms are voluntarily measuring and reporting climate-related risks and climate effects. We also calculated how assets in Swedish insurance undertakings align with the climate goals in the Paris Agreement, where countries from all around the world agreed to keep global warming well below 2 degrees.[2] To reduce emissions, the price on emitting carbon dioxide and other fossil fuels needs to increase in many parts of the world. To better understand and manage the transition risk associated with future price increases, FI advocates that firms use internal carbon pricing and disclose this information externally.

Just over five years have passed since the climate summit in Paris. The EU has presented a strategy for achieving climate neutrality by 2050, and Sweden by 2045.[3] Despite broad consensus for the goals, global emissions are still too high to meet the goals of the Paris Agreement. According to the UN's Intergovernmental Panel on Climate Change (IPCC), major changes are needed to meet them, and time is running short. We must take immediate action, but also be

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1 Task Force on Climate-Related Disclosures. TCFD are recommendations on how firms can report information about how they are managing climate-related risks and opportunities in their business.

2 Uppdrag till FI om uppföljning av finansmarknadsaktörers klimatrapportering [Assignment to FI on following up on climate-related reporting by financial market operators] (Fi2020/01920/FMASTAB)

3 The target means that the emissions of greenhouse gases from Swedish territories will be at least 85 per cent lower in 2045 than they were in 1990. In addition, zero net emissions to some extent can be achieved by increased uptake by forests and land, emission decreases implemented outside of Sweden's borders, and separation and storage of carbon dioxide.

strategic and focused; otherwise, the transition might be disruptive and disorderly.

Financial firms need to actively pursue more sustainable development. This entails enhancing transparency about their exposures to both physical climate risks and transition risks. This also requires developing best practices in the application of new rules and sharing information to learn from one another. To be credible in the eyes of increasingly climate-conscious customers, and to reduce downside risk when the price of carbon emissions increases, financial firms need to also refrain from financing businesses that are not environmentally sustainable in the long term and do not have a realistic strategy to transition. Some Swedish companies have come far when it comes to transparency and transition; the others would be wise to raise their ambition level and learn from those who are best in class.

Stockholm den 18 mars 2021

Erik Thedéen

Director General

The climate in focus

Sustainability is a broad term. One of FI's tasks is to promote the financial system's contribution to sustainable development in a broad sense. But it is also important to set priorities within this scope.[4] FI is currently focusing its sustainability work on the climate, where developments are introducing substantial risks for both society and the financial system, and there is widespread international consensus that change is needed. In 2020, FI was also given an assignment to follow up on the climate reporting of financial market participants.[5]

Climate change is giving rise to physical and economic risks that are large, in terms of both potential scope and potential negative impact. We need to adapt our societies to the new conditions that are emerging from climate change. The transition to a fossil-free economy is not free from risk, and many businesses need to adapt at a fundamental level to survive. Others will need to be shut down.

The financial market and financial firms can contribute to an orderly transition by doing what the market is good at – allocating capital and risks and encouraging innovation. This will also appeal to investors, who are increasingly demanding sustainable investments.

As FI has mentioned in several contexts, it is not part of our mandate to raise or lower the capital requirements for certain types of exposures for the sole purpose of promoting sustainable development.[6] FI is also not allowed to forbid financial firms from financing environmentally unsustainable businesses and activities. However, FI can, and must, require that financial firms consider and manage relevant risks. This may mean that financial firms need to reduce their financing of activities that are not sustainable in the long run or hold more capital in relation to, for example, climate risks. This applies to both short-term and long-term risks. Given this, FI takes the position that it is also time for more financial firms to start to disclose their exposure to environmentally unsustainable activities and the risks that accompany these exposures. This also strengthens consumer protection for those who are asking for sustainable financial products.

4 Section 2 of Finansinspektionen's Instructions Ordinance (2009:93).

5 See "Uppdrag till FI om uppföljning av finansmarknadsaktörers klimatrapportering" [Assignment to FI on following up on climate-related reporting by financial market operators] (Fi2020/01920/FMASTAB)

6 See e.g. FI's opinion on the memorandum "En översyn av regleringen för tjänstepensionsföretag", available in Swedish. https://www.fi.se/sv/publicerat/remissvar/2020/yttrande-over-promemorian-en-oversyn-av-regleringen-for-tjanstepensionsforetag/

A need for stronger information chains

Interest in sustainable investments is growing among both small savers and professional asset managers. When it comes to climate change, many private actors are willing to help finance the necessary transition. However, in order to allocate capital efficiently, investors need to be able to set a price on climate-related risks and opportunities. The firms the investors are investing in therefore need to disclose clear, accurate and comparable information about how their activities are being impacted by climate change and how they are working to transition. Strengthening this information chain is currently an important task for both regulators and the private sector, both in Sweden and internationally.

The biggest challenge is not a lack of information. Many firms already publish substantial amounts of sustainability-related information in their annual reports and other publications. Several years ago, a requirement was introduced within the EU that both non-financial and financial firms of a certain size must disclose this kind of information in conjunction with their annual report. So far, however, the specifics on what should be disclosed, and how, have not been regulated. In many cases, firms use different types of voluntary standards and frameworks, which specify what to disclose and how.

One challenge is that it is difficult for investors to assess how firms are impacted financially by different sustainability factors, despite the information disclosed by the firms. Another is that firms outside of the EU are in many cases not subject to any requirements on sustainability disclosures. Taken together, this means that investors do not have a sufficiently good basis on which to make decisions.

Financial firms also need to report how they are integrating relevant sustainability factors in their processes for granting loans and making investments. This is necessary in order to understand how these firms are working to channel capital away from unsustainable activities, and toward sustainable investments. But they also need to disclose how they identify and manage sustainability risks that could impact their financial position.

Efforts to make sustainability-related disclosures from both financial and non-financial firms better, more relevant and more comparable are under way, both within the EU and on a global level.

NEW EU RULES ON SUSTAINABILITY REPORTING

The EU has an ambitious action plan for financing sustainable growth that was adopted by the European Commission in 2018. As part of the EU’s work on its Green Deal, the Commission is planning to revise its strategy for sustainable growth. The idea is that the financial market and its participants can play an important role in getting the economies of Member States to increasingly take sustainability into consideration. The climate transition that has to happen to reach the EU's climate goals requires significant investments that are only possible if a large part of the financing comes from the private sector via the financial market. More and more participants are voluntarily participating, but the EU wants to speed up the process through regulation.

An important feature of the EU's action plan consists of rules on how both financial and non-financial firms disclose different types of sustainability information.

The *Non-Financial Reporting Directive (NFRD)*, which was decided in 2014 and first applied in 2018, contains requirements on some firms to produce a sustainability report in conjunction with their annual report. This report should include an account of the firms' work with ESG factors, which in the directive are identified as environmental protection, social responsibility and the treatment of employees, respect for human rights, and anti-corruption and bribery.

According to the European Commission's guidelines on how to report non-financial information according to NFRD, firms can fulfil their obligations by disclosing climate-related information in accordance with the recommendations drawn up by TCFD.[7]

The European Commission is currently reviewing the Directive.

The EU has recently decided on two new regulations that contain provisions on sustainability reporting for the securities market. The regulations supplement the requirements on sustainability reporting set out in the NFRD. They aim to create a more uniform structure for sustainability-related disclosures by different types of participants on the securities market.[8]

The EU's *Sustainable Finance Disclosure Regulation* (the Disclosure Regulation or SFDR*)* was decided in December 2019.[9] It regulates how financial market participants[10] should disclose to their investors and their customers both how they integrate sustainability into their

7 See *Supplement on reporting climate-related information in the Commission's Guidelines on non-financial reporting*, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52019XC0620%2801%29

8 On 7 December 2020, FI published more in-depth information on the rules and on the timetable for the legislative work within the EU, available in Swedish. /.

9 Regulation (EU) 2019/ 2088.

10 "Participants on the financial market" refers to fund management companies, insurance companies and financial advisors. Credit institutions only refer to those providing portfolio management and then only for that part of the operations.

activities and sustainability-related information about the activities for which they provide different forms of financing. The SFDR applies the same broad definition of sustainability as the NFRD.[11]

The *Taxonomy Regulation* was adopted in June 2020 and contains rules for determining when an economic activity should be considered environmentally sustainable.[12] The Regulation affects several groups of participants. It requires firms subject to the NFRD to estimate what percentage of their activities that meet the criteria for being considered environmentally sustainable. It also requires financial market participants that are subject to the Disclosure Regulation and offer environmentally sustainable financial products to disclose the extent to which the underlying investments in each such product are invested in activities that meet the criteria set out in the taxonomy.

The taxonomy provides a common starting point for what is to be considered an environmentally sustainable activity. This makes it possible to identify and compare different investments based on how well they contribute to reaching a sustainable economy. The idea is for the taxonomy to serve as a basis for future EU standards and labelling of sustainable financial products. It includes, as a first step, criteria that an activity must meet to be considered to contribute to limiting climate change or to adapting society to climate change. As a second step, the taxonomy will be expanded to include criteria linked to the EU’s four other environmental goals: the sustainable use and protection of water and marine resources; the transition to a circular economy; pollution prevention and control; and the protection and restoration of biodiversity and ecosystems. In order to be classified as environmentally sustainable, an activity must furthermore meet certain requirements on employee protection.

The Disclosure Regulation is the first regulation to be applied. As of 1 January 2022, financial firms must start to disclose sustainability factors in regular reports. But financial market participants are required already as of 10 March 2021 to disclose certain sustainability information on their website and in information provided prior to entering into agreements.

Firms must work actively to adapt to new rules

At this stage of the work, FI is focusing on ensuring that firms are working actively to adapt to the new requirements and then begin to apply them as they enter into force. An important part of this work is to pursue a dialogue with the industry to inform about, and discuss the impact of, the new rules, and to answer any questions. FI therefore held during the year a number of roundtable discussions, meetings with industry associations, and other dialogue meetings. FI encouraged the firms to prepare by, for example, systematically

11 Directive (EU) 2014/95.

12 Regulation (EU) 2020/ 852.

identifying sustainability factors in activities and reviewing how sustainability risks can be managed in their own processes for governance and reporting. The Taxonomy Regulation does not enter into force until January 2022, but it is important that firms start adapting to the new requirements that will be introduced by the regulation.

FI has also participated in the design of the proposed regulatory technical standards (RTS) that the Joint Committee for the European supervisory authorities for the financial sector (European Banking Authority (EBA); European Insurance and Occupational Pensions Authority (EIOPA); and European Securities and Markets Authority (ESMA)) recently presented to the European Commission.[13] These standards specify in more detail the information that firms must disclose under the new requirements. There will be a gap between when the Disclosure Regulation on sustainability-related disclosures enters into force and the related delegated acts – the RTS – enter into force. During this transition period, however, the drafts of the delegated acts can provide important guidance. FI therefore stands behind the statement made by the Joint Committee recommending that authorities and financial market participants use the drafts of the delegated acts in their preparations.[14]

REPORTING PLAYS A KEY ROLE

Many of the conceivable effects of climate change and the transition are negative for firms that do not adapt their operations in time. These include not only direct physical risks, such as sharp falls in asset values or disrupted production and delivery flows, but also market-driven changes that alter demand and the prices of input goods. Combined with an expected increase in the price on carbon emissions, such a development could have far-reaching effects on cash flows and earnings. Firms' earnings can also be impacted by rising costs for investments to reduce emissions and develop new technology. At the same time, firms with a sustainable focus and sustainable development could experience greater demand, which could have a positive impact on cash flows and earnings as well as on the value of the firm.

It is becoming increasingly clear that sustainability factors impact a firm's exposure to risks and opportunities, which in turn impacts the value of the firm. However, despite firms' sustainability disclosures, in many cases investors are currently not able to assess how a firm is impacted by such developments or how their exposure to sustainability risks and opportunities changes over time. This is due to

13 See the EU's draft on regulatory technical standards, https://www.esma.europa.eu/press-news/esma-news/three-european-supervisory-authorities-publish-final-report-and-draft-rts

14 See EU-myndigheter vägleder om kommande hållbarhetsrapportering, https://www.fi.se/sv/publicerat/nyheter/2021/eu-myndigheter-vagleder-om-kommande-hallbarhetsrapportering/. The pages on FI's website are available only in Swedish, but the linked EU pages are in English.

several reasons. One reason is that firms seldom express the consequences of sustainability factors in economic terms, and the information is often backward-looking instead of forward-looking. Firms' sustainability reporting is also usually presented in an annual report that offers a snapshot-in-time of the firm's sustainability work and exposure to sustainability risks and that external stakeholders may have difficulty following up on during the financial year. This is in contrast to financial statements, where firms' annual reports and interim reports together aim to provide investors, customers and other external stakeholders with complete, relevant, and up-to-date information on the business and changes to the firms' earnings.

In order for climate- and transition-related disclosures on risks and opportunities to be fully usable, investors need to better understand the resulting financial impact and how this impact can change over time. A greater focus on sustainability also means that investors want to have more ongoing and updated reporting on the developments in the firms' sustainability work, including how well firms are meeting targets they have set, for example for reduced emissions.

Exactly how the climate will change or how the transition will be carried out is currently an unknown. Therefore, firms need to apply a forward-looking approach to their work and use different scenarios to assess what the financial impact might be. Even if there is little change in the short term, for example from quarter to quarter, there may be a need for firms to also report throughout the financial year, for example in interim reports, on the development of several central sustainability indicators based on their established climate goals. Overall, this could contribute to greater transparency and also give investors and other stakeholders better possibilities for putting pressure on firms that are exposed to large transition risks.

GLOBAL STANDARD FOR SUSTAINABILITY REPORTING UNDER WAY

Financial firms are often middlemen. If they are to be able to meet the strict transparency requirements on their own exposures, it is essential that the businesses they are working with also disclose sustainability information about their own activities. Today, this information is neither uniform nor comparable.

It is therefore a priority for FI, as a supervisory authority, to get a uniform standard for sustainability reporting in place that ensure investors receive information they need and meets requirements on reliability and comparability.

This is a global challenge. We are therefore pursuing a solution together with supervisory authorities around the world through the International Organisation of Securities Commissions (IOSCO), where FI heads a working group on sustainable finance. IOSCO played a key role in developing the global standard for financial reporting (IFRS) twenty years ago.

Two global initiatives that were launched in the autumn of 2020 are paving the way forward. First, the leading organisations that develop frameworks and guidelines for sustainability reporting, including the Sustainability Accounting Standards Board (SASB) and the Global Reporting Initiative (GRI), have agreed to work toward more coherent and uniform sustainability reporting worldwide. Second, the organisation behind the IFRS has proposed that they set up an administrative structure for sustainability reporting similar to the one that currently exists for financial reporting. The intention is to coordinate these two initiatives. The goal is for IFRS to be able to use the standard-setters' work when developing a global standard for how firms should disclose sustainability-related information.

IOSCO has once again taken an active role in ensuring that a future standard meets the requirements on content and credibility that would enable it to become an integral part of the regulatory financial reporting framework. This work is progressing at a very rapid pace, and FI expects the parties involved to be able to present a proposal for such a standard already ahead of the next climate meeting, COP26, which will be held in Glasgow at the beginning of November this year (2021).

A FRAMEWORK FOR THINKING ABOUT SUSTAINABILITY REPORTING

As part of FI's work to develop a framework for our own thinking on sustainability reporting, we commissioned a report in 2020 from Torkel Strömsten, a researcher in financial reporting at the Stockholm School of Economics, that places the work on sustainability reporting into a larger context related to the fundamental functions, aim and development of financial reporting over time.[15]

The report describes, for example, how sustainability reporting has developed in relation to financial reporting. The focus is on climate-related risks and how these can become part of the financial reporting. The author asserts in the report that there is a need to create a uniform global standard and it is important to audit the sustainability information. This, in turn, could lead to greater transparency and comparability as well as greater confidence in firms' disclosures.

15 Hållbarhetsrapportering och behoven av ökad transparens och jämförbarhet, see https://www.fi.se/sv/publicerat/rapporter/rapporter/2020/hallbarhetsrapportering-och-behoven-av-okad-transparens-och-jamforbarhet/. Available in Swedish. See also Strömsten, T. (2021) *On the interface between financial and sustainability reporting: Climate Related Financial Consequences*. Misum Academic Insights. March 2021

TCFD LEADING THE WAY

It can be tempting for firms to put off efforts in the area of sustainability reporting in anticipation of a globally binding standard. FI takes the position that firms have much to gain from already starting to prepare now. If a firm focuses early on issues such as own risk analysis, data gathering, and presentation of the information, the experience it gains will make it better equipped to quickly meet coming requirements. If the Swedish private sector starts to adapt now, this could also contribute to a rapid and orderly transition by paving the road for financing of the large investments that are needed.

An appropriate first step is to disclose information in accordance with the TCFD recommendations. This is also in line with the European Commission's guidelines on how firms can report non-financial information in accordance with the NFRD.[16] The TCFD recommendations provide good guidance and are based on four central components of a firm's operations: governance, strategy, risk management, and metrics and targets. A recent report published by TCFD shows that 1,600 companies around the world are now following the recommendations to some degree, and a number of countries, including the UK and New Zealand, have announced they will introduce binding legislation for firms to follow the TCFD recommendations.

In Sweden, 19 per cent of the largest companies listed on the Stockholm Stock Exchange apply the TCFD recommendations to their sustainability reporting, but to varying extents. Ten per cent have officially announced that they stand behind TCFD and are thus committed to reporting in accordance with the recommendations.[17]

TCFD is currently voluntary in the EU but is likely to become more binding for larger firms in the future, for example as a result of the ongoing review of the NFRD. The European Securities and Markets Authority (ESMA) specifies every year which areas the supervisory authorities should prioritise. This year, the priority is on listed firms' climate reporting, in part with a reference to the Commission's recommendation to comply with the TCFD.[18]

INTERNAL CARBON PRICING HELPS FIRMS TRANSITION AND MANAGE RISKS

An important part of the work to improve sustainability reporting is to identify information and metrics that can reflect a firm's vulnerability to transition risks. One such metric is a firm's internal carbon price,

16 See *Supplement on reporting climate-related information in for Commission's Guidelines on non-financial reporting*, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52019XC0620%2801%29

17 Data from the consultancy firm 2050's Transparency Index for 2020.

18 See *European common enforcement priorities for 2020 annual financial reports*, https://www.esma.europa.eu/sites/default/files/library/esma32-63-1041_public_statement_on_the_european_common_enforcement_priorities_2020.pdf

i.e. the cost the firm itself sets on its carbon emissions. Compared to the social cost of emissions, the price on emitting carbon dioxide and other greenhouse gases is too low in many parts of the world. As a result, the investments being made to transition our societies to low emissions are too small. This also means that some firms that are profitable today may experience problems if emission pricing were to move toward levels more appropriate from a social perspective. A low price on emissions is thus a problem from both an efficiency and a stability perspective.

Against this backdrop, FI started an initiative in 2020 at both the national and international level to encourage more firms to apply an internal price on carbon. A number of firms in Sweden and globally already use internal carbon pricing. FI has made it clear that more firms should do this and also report this information externally. Over the past year, we pursued a dialogue with both non-financial and financial firms in Sweden about how they use, or could use, internal carbon pricing. As part of this work, FI is also publishing an FI Analysis where we present the economic arguments for using an internal price on carbon and how firms can work with this tool.[19]

Working with internal carbon pricing is one way for firms to better assess the financial impact of future climate measures and the risks of not transitioning. It can create incentives to transition to more sustainable activities. It can also increase private sector support for higher market prices on carbon emissions. If firms also report how they work with internal carbon pricing, this could make it easier for investors and other external stakeholders to identify transition risks.

19 See “FI Analysis 30: Internal price on carbon – what and why?”

Integrating sustainability in financial activities

In many respects, sustainability-related risks and opportunities are no different than other types of risks and opportunities associated with financial firms' activities. As FI has pointed out on a number of occasions, these matters should be a natural part of the financial firms' work. Financial firms must conduct an aggregate risk assessment, and in this analysis we expect them to consider sustainability factors that are relevant for their activities. Financial firms should integrate these assessments into their processes for issuing credit, making investments, and underwriting insurance policies.

To achieve this, financial firms need to integrate sustainability into the governance of their operations. In order for customers and other stakeholders to understand how the financial firms are working with such matters, these firms also need to report their targets for this work and the concrete steps taken to achieve the targets.

Many financial firms are increasing the share of sustainable investments and sustainable loans in their portfolios. This is an important contribution toward financing the transition to a sustainable society and a way for financial firms to benefit from the opportunities that will follow from this transition. At the same time, financial firms also need to manage financial risks arising from both climate change and the transition. Due to the climate goals that the majority of the world's countries have committed to, activities that emit large amounts of greenhouse gases, are dependent on fossil input goods, or have business models that require continued low emission prices are exposed to significant transition risks. By investing in such activities, financial firms expose themselves to corresponding risks. In the long term, this could also pose risks for financial stability.

In the short term, and perhaps the medium term as well, many of the firms that are active in industries with a strong negative impact on the climate will be profitable. Financing these activities, therefore, will not necessary result in immediate credit risks or investment risks. However, from a long-term perspective, climate measures, for example in the form of rising emission prices, could cause loss risks for banks and other financial firms that are financing these activities.

When an individual firm does not manage its risks properly, it may experience a decline in profits, which could also impact consumers and investors. However, when there is a failure at the systemic level to identify, measure and price risk, the consequences can be substantially larger. Therefore, financial firms need to take a long-term approach in their risk management work and review their financing of environmentally unsustainable activities. This may imply reducing their financing of certain types of activities. Financial firms can also make demands on firms with a strong negative impact on the climate to rapidly take steps to transition their business model in a more sustainable direction.

FI has previously outlined how financial firms integrate sustainability factors in general, and climate factors in particular, in their operations, and how they disclose this information.[20] FI followed up on the results in its supervisory dialogues. FI sees an increasing awareness among financial firms about the financial impact of climate change and the transition and that more and more firms are working to incorporate these matters into their business.

MEASURING AND REPORTING CLIMATE RISKS AND CLIMATE IMPACT

As part of an assignment from the Government in 2020, FI reviewed how far Swedish financial firms had come in their work to measure and report climate risks and climate impact. In the autumn, FI sent a survey to the majority of insurance undertakings and a number of large banks and fund management companies.

The results of the survey, which are described in more detail in Appendix 2 to this report, confirm that the firms are working on these matters but in many ways are still in a start-up phase. Only a few firms have processes in place for the entire chain of identifying, measuring, assessing, and managing climate risks. The firms report a lack of tools and data as one of the key reasons for this. That is a problem, and FI expects firms to earmark resources to measure the risks and gain an understanding of the consequences of these risks. In their work, firms should use existing tools to broaden their understanding of the scope of the risks but also actively participate in the development of methods and best practice in the area.

Many firms analyse the presence of different types of transition risks linked to fossil fuels, for example, and the physical risks in their portfolios resulting from, for example, rising sea levels and extreme weather events. Fewer firms, however, are measuring how their portfolios align with the climate goals in the Paris Agreement. Even fewer report their results externally.

Transparency among firms about how they are working with sustainability forms an important basis for the decisions of investors and customers, and reporting can also constitute an internally strategic tool that helps firms review their activities and become more aware about risks and opportunities.

The firms' responses to the survey confirm that public disclosure is important and voluntary reporting initiatives contributed to greater

20 See the reports "Integrering av hållbarhet i företagsstyrningen", "FI-tillsyn 6: Hållbarhetsinformation i fonder", and "FI-tillsyn 7: Hållbarhetsperspektiv vid kreditgivning till företag – en uppföljning", available in English. https://www.fi.se/sv/publicerat/rapporter/.

transparency and awareness surrounding climate risks. The firms state that the reporting has helped them increase their internal focus on climate risks and raise their requirements on suppliers and the customers they are financing.

The majority of the firms that are subject to the sustainability reporting requirements set out in the Annual Accounts Act use voluntary frameworks and standards, either fully or in part, in their reporting. Many consider this to be necessary to meet the requirements set out in the Annual Accounts Act. An analysis conducted by FI in 2018 showed that the rules only specify at a general level the information that firms must disclose.[21] One clear trend is that the TCFD has gone from being one of the most important voluntary recommendations for firms to follow in 2018 to being the single most important in 2020. An increased focus on the TCFD recommendations could be a sign that the firms are aware of and preparing for the international regulations. Some financial firms also encourage the firms they are investing in to apply the TCFD recommendations. Fund management companies also highlight the European Commission's non-binding guidelines for the reporting of non-financial information as an important standard they are following.

The firms are also experiencing that sustainability reporting is resource-intensive. Several also mention that the reporting frameworks are disparate. The need to develop a best practice and learn about the experiences of others to continue to progress in this area is also a topic the firms brought up in their supervisory dialogues with FI. FI therefore held several roundtable discussions during the year to create a forum for firms to share experiences and learn from one another.

The survey responses show that the majority of the firms see a need for measures from the Government and other actors to improve the measurement of climate risks and climate impact. They consider there to be a need, for example, to harmonise regulations and definitions and for authorities to provide relevant data and models. They also take the position that the Government and authorities should help clarify and harmonise the regulations and initiatives that are currently present in the area of sustainability.

21 See the report "Integrering av hållbarhet i företagsstyrningen", available in English. https://www.fi.se/sv/publicerat/rapporter/

Scenario analysis pinpoints transition risks

Climate change and the climate transition entail a large number of significant changes over long time horizons, in complex ecological and social systems. This makes it difficult to predict the future. The uncertainty increases the longer the time horizon, and much of this uncertainty is genuine in that risks are particularly difficult to translate into probabilities.

When uncertainty is high, it is important to conduct scenario analyses. This applies to both financial firms and authorities conducting supervision and monitoring systemic risk. The TCFD also recommends that firms should use scenario analyses.

Scenario analysis is a systematic way to analyse and describe different possible outcomes of uncertain future conditions. These analyses can help identify and accept uncertainty. They can also enhance the ability to manage unexpected outcomes. This helps firms and authorities make well-founded decisions that deliver acceptable outcomes despite the considerable uncertainty.[22]

Risk management, including scenario analysis, is a core activity for many financial firms. Firms should include in this work climate-related risks that are of material significance for their business. Business models that are based on low carbon prices, that emit large amounts of carbon or are dependent on fossil-intensive input goods, are vulnerable to increases in carbon pricing. This is one example of *transition risk*, i.e. a risk caused by changes to the market or by society's measures for limiting the negative impact on the climate and not from the climate change itself. Scenario analysis can facilitate the management of such risks. It can also promote a redirection of capital flows to investments that are sustainable from a climate perspective.

PILOT STUDY ADOPTING NEW METHODS

One way to assess transition risks in financial firms is to analyse how aligned their exposures are to national or global climate goals. One particularly relevant climate scenario is limiting global warming as set out in the Paris Agreement. More and more investors want information about the extent to which a firm’s activities, in a forward-looking perspective, are aligned with the goals of the Paris Agreement. In a letter to thirty-six of the largest European power, commodities, and transport firms, institutional investors recently expressed their expectations that firms disclose how they are impacted by the Paris Agreement’s commitments to limit global warming. The

22 See Wedebrand C. (2020). *Planering under osäkerhet. Om att planera för de okända inom krisberedskapen, totalförsvaret och andra områden.* FOI-R--4972—SE.

letter's signatories represent SEK 90,000 billion in capital, or almost 20 times the Swedish GDP.[23]

FI recently conducted a pilot study among insurance undertakings using the PACTA tool, which measures the extent to which portfolios with financial assets are aligned with climate scenarios.[24] The study identifies the percentage of insurance undertakings' portfolios that are invested in carbon-intensive sectors and how the portfolios relate to the climate goals of the Paris Agreement.[25] Underlying data refers to investments in shares and corporate bonds, but a few months ago a version of the tool was also introduced that makes it possible to analyse banks' credit exposures.[26]

One aim of the study was to increase FI's knowledge about the approach itself in this type of analysis rather than the actual tool. Increasing transparency on transition risks is also part of FI's assignment.[27] Financial firms need to carry out this type of analysis themselves. This is one reason why supervisory authorities should enhance their understanding of the methods, but FI also needs to be able to carry out its own calculations.

Insurance undertakings make a good study sample since they have large assets and are often long-term owners. How they choose to invest their managed capital can thus play a major role. It is also in the interests of non-life insurance and reinsurance undertakings to facilitate the transition since large risks that are difficult to assess could impair the functionality of the insurance markets. Climate change could also mean that certain criteria for firms to be able to offer insurance will no longer be fulfilled in the future. For example, damages, in order to be insurable, need to be sudden and unexpected.[28] Given this background, AXA, one of Europe's largest insurance undertakings, recently recommended a cooperation between insurance undertakings to take steps towards ensuring that their investments are aligned with the Paris Agreement.[29]

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23 See https://www.iigcc.org/download/iigcc-letter-to-european-companies-on-paris-aligned-accounts/?wpdmdl=4006&masterkey=5fabc9c5af24f. See also IIGCC (2020). [IIGCC (2020), *Investor Expectations for Paris-Aligned Accounts*. London: Institutional Investors Group on Climate Change.]

24 See Appendix 1 for a more detailed description of the PACTA tool.

25 The climate-relevant sectors that are included are power, auto manufacturing, oil, coal and gas extraction, steel and cement manufacturing, aviation and shipping.

26 See https://www.transitionmonitor.com/pacta-for-banks-2020/

27 In 2020, FI's assignment description was expanded to include that FI should work to ensure that the financial system contributes to sustainable development. FI also received an additional assignment from the Ministry of Finance, namely to monitor and take necessary measures under the voluntary initiative "Enhancing Transparency and Aligning Private Financial Flows with the Paris Agreement".

28 https://www.svenskforsakring.se/globalassets/faktablad/svensk-forsakring-faktablad/k5_klimatblad.pdf

29 https://www.axa.com/en/magazine/AXA-celebrates-the-fifth-anniversary-of-the-Paris-Agreement-and-calls-for-new-commitments

RESULTS AND CONCLUSIONS OF THE STUDY

In general, the analysis implies that the investments of Swedish insurance undertakings are not aligned with the Paris Agreement. The calculations indicate that a majority of the insurance undertakings deviate negatively from a climate scenario aligned with the Paris Agreement.

The analysis, which is described in more detail in Appendix 1, also shows that insurance undertakings in general have small exposures to carbon-intensive sectors in relation to their total assets. This could be an indication that they have limited *direct* transition risks in their portfolios. However, there are individual insurance undertakings that have relatively large exposures, which could indicate high direct transition risks. In order to determine this, more analysis is needed.

The approach of the PACTA tool fulfils an important need, namely to analyse asset portfolios in relation to climate scenarios. The analysis tool is promising and publicly available for all to use, but the quantitative results should be interpreted with caution for several reasons.[30] One is that the analysis in the pilot study is limited to a sample of corporate bonds and shares in what the analysis tool defines as *climate-relevant sectors*, given accessible climate-relevant data. Other sectors and securities, such as treasury bonds or banks' covered bonds, are not included. Since insurance undertakings have large exposures to these types of bonds, the analysis describes merely one part of the overall picture. Only around 6 per cent of the insurance undertakings' share holdings, and just under 1 per cent of their bond holdings, were classified as carbon-intensive. This means that exposures to other types of activities, which can also be exposed to both direct and indirect transition risks, were not considered. The analysis thus probably underestimates the insurance firms' exposures to activities that could be vulnerable to a transition.

The pilot study has increased our understanding of how this type of analysis tool works and how well they capture climate risks. The methods are still incomplete, but this area is developing quickly. The calculations also require large amounts of data in an area where information is currently far from comprehensive. However, access to data is consistently improving given the high demand for climate-related data and stricter requirements on firms' climate-related disclosures. The possibilities for analysis will thus improve. FI will continue to build up competence in this area and participate in work that is currently under way, particularly on the international level, by developing and applying tools that give us a better overview of the climate risks in the activities of financial firms. We encourage financial firms to do the same and to contribute to the development of

30 For a more detailed discussion on the strengths and weaknesses of the tool, see Appendix 1.

methods and to increased transparency around the transition risks in their activities.

INTERNATIONAL COLLABORATIONS TO DEVELOP NEW METHODS

FI is participating actively in the international work to assess how climate risks are transmitted to the financial system and to develop methods for measuring the risks. Work is underway within the global Network for Greening the Financial System (NGFS), the Basel Committee, and the European Systemic Risk Board (ESRB).

During the year, FI led a project within the NGFS to analyse how banks across the world are considering climate-related risks in their lending and how they are working to assess climate-related risks in their credits. Two Swedish banks participated in the analysis.

The analysis shows that banks are increasingly considering climate-related risks. But it also shows that it is difficult to classify credits according to the level of climate-related risk. There are several reasons for this, one of which is that there is no international classification system and no consensus on which assets are sustainable or unsustainable from a climate perspective. This will be somewhat rectified by the pending EU taxonomy. Another reason is that there are still no tools that enable forward-looking analysis of these risks.

The work to analyse potential differences in risk between environmentally sustainable and unsustainable assets is progressing. FI is also participating in the project on climate-related financial risks that the Basel Committee began at the start of 2020. This project aims to describe in more detail how climate risks are transmitted to the financial system and the methods that can be used to measure these risks. The Basel Committee will publish reports during the first half of 2021. The conclusions in these reports will serve as a basis for the committee’s continued work.

FI integrates sustainability into its operations

FI's assignment and activities in the area of sustainability are multifaceted. As presented in earlier sections of this report, we are to a great extent focusing on participating in the development of regulations and standards, advocating efficient implementation of regulations in Sweden, and promoting better disclosure from all relevant firms. But FI also has the objective to integrate sustainability as a natural part of its ongoing follow-up of the firms under its supervision.

In 2021, taking pending EU regulations as a starting point, we will prioritise guidance and following up on the firms' work with sustainability and related reporting. Each firm is responsible for ensuring that it can comply with the regulations. FI can help facilitate this work by pursuing a dialogue with both individual firms and industry representatives to answer questions and develop best practices.

Our ambition is for Swedish financial firms to be at the forefront of the application of the new requirements, and we will highlight this in particular during our follow-up. We will also continue to measure the climate-related risks in the financial firms' portfolios, and continue to take an active role in the ongoing work to develop a global standard for sustainability reporting. [31]

We list below several sustainability-related activities that we intend to carry out in the near future.

BANKS

In the banking area, we are now integrating sustainability perspectives into our review of business model risks and credit risks. The goal is to develop and adapt the methods used to assess these risks in order for them to capture sustainability aspects.

When it comes to the analysis of business models, our work will focus on how banks consider sustainability risks when assessing the profitability forecasts of their business plans and strategic plans.

In terms of the assessment of credit risk, the method will be adapted to include sustainability risks in the banks' risk management work as well as inherent risks in the banks' credit portfolios.

31 https://www.fi.se/sv/publicerat/sarskilda-pm-beslut/2021/finansinspektionens-prioriterade-omraden-for-2021/

The plan is to include in this year's ongoing risk assessment an assessment of the sustainability aspects in these two areas. As part of this, FI is planning to ask the banks a number of questions about their exposures and strategies related to sustainability at the periodic supervisory dialogue. We will also conduct general assessments of the banks' credit portfolios based on their exposures to sectors that risk being particularly exposed to sustainability risks.

FI encourages banks to pre-empt coming regulations

Enhanced transparency around climate-related risks in banks' credit portfolios, and how their lending aligns with climate goals, is one area that FI will prioritise. For non-lending activities, new pending EU regulation introduces stricter requirements on transparency. For banking, similar regulations are under development. There are already far-reaching and detailed proposals from the European Banking Authority (EBA) on how banks should disclose sustainability risks in their Pillar 3 reports.[32]

FI takes the position that it is crucial that also banks start to report more on their exposure to climate risks. FI is therefore encouraging banks to pre-empt the coming regulations, in the sense of aligning with upcoming requirements in advance of them becoming formally binding. More transparent reporting could include a detailed account of lending volumes to firms in climate-affecting sectors in absolute amounts and as a share of the total portfolio, and the environmental impact of this lending expressed in terms of, for example, carbon emissions. In order to improve transparency around transition risks in credit portfolios, banks need to start to use to a larger extent analysis tools, like PACTA, which helps them gain a better overview of the risks in different exposures and the portfolios' alignment with climate goals.

FI will pursue a dialogue with the banks on these matters, and we will also announce in the spring how we will proceed in the work to measure the climate-related risks in the banks' credit portfolios.

INSURANCE UNDERTAKINGS

FI is continuing to develop risk analyses for the supervision of insurance undertakings based on both the survey of the firms' sustainability work and the pilot study of the PACTA tool conducted in 2020. Through these information gathering activities, FI has obtained greater knowledge about the undertakings work and how far they have come in integrating sustainability into their operations, governance and risk management. This information will be used in the development of the risk and impact classification that serves as a basis for our work with sustainability-related risks and their impact.

32 https://www.eba.europa.eu/eba-launches-public-consultation-draft-technical-standards-pillar-3-disclosures-esg-risks

The pilot study using the PACTA tool has provided us with an understanding of the insurance undertakings' exposures to climate-relevant sectors. In 2021, FI will continue to work with the PACTA tool and analyse how it can be used in supervision and to quantify transition risks.

Insurance undertakings are currently adding sustainability aspects to their own risk and solvency assessments (ORSA). FI is following how the undertakings are managing sustainability-related risks in their reporting. We are also participating actively in ongoing efforts at the EU level to integrate sustainability matters into the review of firms' ORSAs.

Just like the insurance undertakings, FI will continue to work on implementing pending EU regulations in the area of sustainability. In addition to analysing how the regulations are to be integrated into supervision, FI is pursuing a dialogue with the industry to provide information and answer the firms' questions.

The Government is expected to submit a bill in the near future that would amend the regulations for occupational pension undertakings. As a consequence, FI intends to submit for consultation regulations that entail lower capital requirement for investments in infrastructure if they meet certain sustainability criteria.

SECURITIES MARKETS, FUND MANAGEMENT COMPANIES AND INVESTMENT FIRMS

In 2020, a legal analysis was performed to identify relevant regulations that currently include sustainability aspects. This analysis, which will be updated annually, is an important contribution to the work to identify sustainability-related risks in firms and to frame the supervision.

In 2021, FI will focus heavily on integrating new EU requirements into its supervision. Due to the new regulations – primarily the Disclosure Regulation and the Taxonomy Regulation – both firms and FI are in an intense development phase, where a lot of the work aims to establish processes and develop best practice. An important part of this is to continue to pursue a close dialogue with the industry – roundtable discussions, meetings with industry associations, and other dialogue meetings – with the goal of discussing and providing information about new legislation and answering firms' questions.

In its market supervision FI will also monitor so-called greenwashing, i.e. firms describing their activities and products as more sustainable than what they are in practice in order to increase sales or gain easier access to financing. There is also a risk that fund savers are paying too high of a fee. FI is therefore planning to map some of the funds that use sustainability or similar terms in names or information for consumers. This survey will primarily focus on fund management companies that have not previously had their sustainability work analysed by FI and funds for which FI for some other reason makes the assessment that there may be a risk of greenwashing.

Appendix 1. Are insurance undertakings' assets aligned with the Paris Agreement? – Results from FI's pilot study

In 2020 FI conducted a pilot study among insurance undertakings using the PACTA tool with the goal of measuring the extent to which portfolios with financial assets are aligned with climate scenarios.

What is PACTA?

The Paris Agreement Capital Transition Assessment (PACTA) is a tool that measures the extent to which portfolios with financial assets are aligned with climate scenarios. It was developed by 2 Degree Investing Initiative (2DII), which is a think tank whose work is financed in part by the European Commission.

PACTA makes it possible to estimate what percentage of an asset portfolio is invested in businesses that emit large amounts of carbon. Using this estimate and available data about how these businesses' production and emissions will change in the next five years, the tool measures how the portfolio aligns with different climate scenarios. The tool thus makes it possible to estimate whether the investments in a portfolio given a forward-looking five-year perspective are aligned with the climate goals in the Paris Agreement.

PACTA uses in its analysis different types of data that can be linked together to one dataset, including

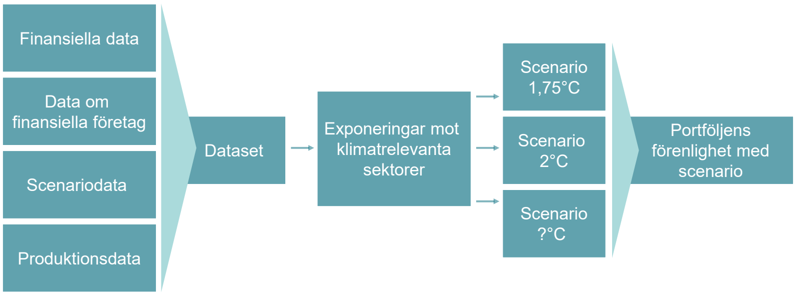
- financial data on firms in climate-relevant sectors (see below)
- data on these firms' current production and how they have communicated that it will change in the next five years
- scenarios for climate change developed by The International Energy Agency (IEA)
- firm-specific data on the financial firms that are included in the analysis and on their assets

PACTA analyses financial firms' exposures to firms in so-called climate-relevant sectors. According to 2DII's calculations, firms in climate-relevant sectors represent around 7–8 per cent of the world's total firms, representing an estimate of around 80 per cent of corporate global carbon emissions. The climate-relevant sectors that PACTA analyses are as follows:

- power
- auto manufacturing
- oil extraction
- coal extraction
- gas extraction
- steel manufacturing

- cement manufacturing
- aviation
- shipping

1. How PACTA works



Source: FI
Note: First, PACTA connects data from the different sources to a joint dataset. Using this data, it analyses what percentage of a portfolio is invested in firms in so-called climate-relevant sectors. This is then followed by a scenario analysis, which calculates the difference between the underlying businesses' planned production and the production that is allowed given a selected climate scenario. The data is aggregated to assess how aligned a portfolio is with the scenario.

In most of the climate-relevant sectors, like the power sector, there are activities that emit large amounts of carbon and activities that emit small amounts of carbon. This is considered in the analysis by dividing the activities into categories based on their carbon intensity.

Carbon-intensive technologies	Non-carbon-intensive technologies
Manufacturing of cars with internal combustion motors Power from coal Power from oil and gas Extraction of oil and gas Extraction of coal All forms of transport/freight Aviation Cement industry Traditional steel production	Renewable energy Hydropower Electricity-driven steel production Nuclear power Manufacturing of electrical cars

FI's pilot study

FI conducted a pilot study using PACTA in 2020. Using the tool, FI analysed the asset portfolios for a sample of insurance undertakings Based on its analysis, FI estimated the insurance undertakings' exposures to businesses that emit large amounts of carbon and therefore could be vulnerable to a transition. Using the scenario analysis made possible by the tool, we also analysed whether the insurance undertakings' asset portfolios are aligned with a 1.75 degree scenario developed by IEA. In this way, FI has been able to assess how the insurance undertakings' portfolios align with the climate goals in the Paris Agreement.

The study included non-life and life insurance undertakings that report their assets in accordance with the Solvency II regulations. FI included in the analysis assets for which the insurance undertakings themselves bear the financial risk for the investments. Thus, holdings in unit-linked and deposit insurance were not included.

Results and analysis

As presented in Table 1 below, PACTA was able to identify and classify 63 per cent of the insurance undertakings' aggregate share and bond holdings.[33] Approximately 6 per cent of these share holdings and just under 1 per cent of these bond holdings constitute exposures to firms in one of the climate-relevant sectors. These figures should be compared to the 7–8 per cent of the firms globally that according to 2DII's classification are included in the climate-relevant sectors.

Table 1. Aggregate results
SEK million

	Bonds	Shares	Total investment assets
Total value of the insurance undertakings' portfolios	1,125,013	1,063,430	3,355,322
Value of the portfolio that was classified by PACTA	705,170	672,152	1,377 323
Share of the portfolio that was classified by PACTA	63%	63%	41%
Exposures to climate-relevant sectors according to PACTA	6,249	43%	49,412
Share of classified portfolio that constitutes exposures to climate-relevant sectors	0.89%	6.42%	3.59%

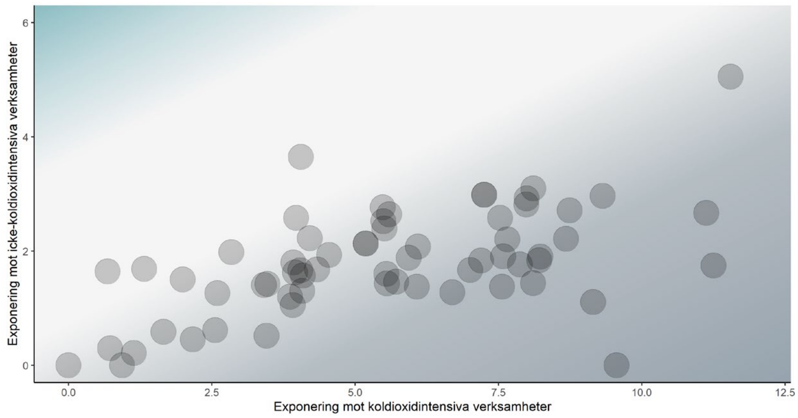
Note: Total investment assets. Share and bond items also include units in equity and fixed-income funds broken down to the underlying assets. The sum of the total investment assets includes all assets, even those that were not included in the analysis, such as treasury bonds and covered bonds. Treasury bonds and covered bonds comprise 76 per cent of the life insurance undertakings' interest-bearing assets and 59 per cent of the non-life insurance undertakings' interest-bearing assets.

Most of the insurance undertakings have a larger share of exposures to carbon-intensive technologies than to non-carbon-intensive technologies (see Diagram 2). However, the share of investments in carbon-intensive technologies varies significantly between the insurance undertakings.

33 This means that the tool has not been able to identify the remaining holdings and thus not been able to assess either whether these constitute exposures to the specified climate-relevant sectors.

2. Exposures to climate-relevant sectors

Per cent



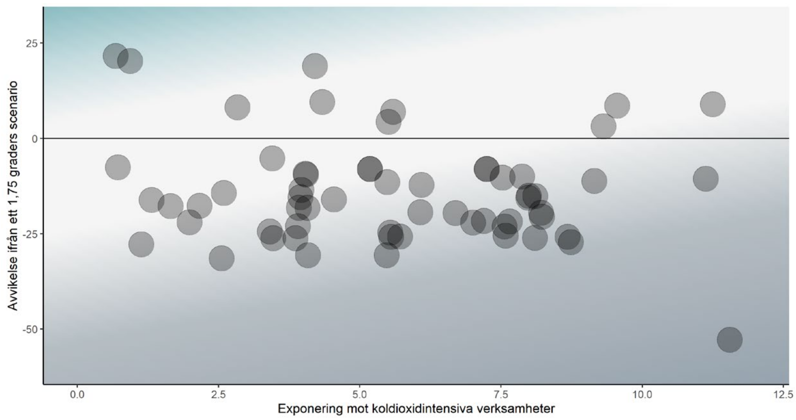
Source: FI

Note: The diagram refers to the share of the insurance undertakings' asset portfolios that is invested in climate-relevant sectors, broken down into carbon-intensive and non-carbon-intensive activities.[34]

PACTA shows that the insurance undertakings' total exposures to climate-relevant sectors are small in absolute terms. However, despite the relatively small exposures to carbon-intensive activities, the majority of the insurance undertakings do not invest in a way that is aligned with a 1.75 degree scenario developed by IEA. Therefore, their asset portfolios are not aligned with the climate goals in the Paris Agreement, either. This indicates that carbon-intensive firms in which the insurance undertakings are investing are not planning to transition or are transitioning too slowly.

3. Alignment of the investments with a 1.75 degree scenario and exposure to carbon-intensive activities

Per cent



Source: FI

34 The analysis considers the size of the insurance undertakings' exposures in absolute terms. However, the diagram illustrates only the percentage of exposures and does not take size into consideration.

Note: Insurance undertakings whose investments are not aligned with the scenario have a negative deviation and fall below the line in the diagram.

The result indicates that the insurance firms only to a small extent are exposed to direct transition risks in the form of exposures to activities with high carbon emissions. But there are firms that have relatively large exposures and at that also deviate significantly from the chosen scenario (to the right in Diagram 3). This could suggest that they have a relatively high exposure to *direct* transition risks in their portfolios. In order to determine if this is the case additional analysis is needed.

Even if the results in general indicate small exposures to activities in carbon-intensive sectors, this should not be interpreted as meaning that the undertakings have small transition risks in general. There are several reasons for this:

- The analysis is limited to insurance undertakings' holdings in a sample of corporate bonds and shares in the climate-relevant sectors and for the assets for which there is climate-relevant data available about the underlying activity. This means that only a very small percentage of the firms' portfolios are included in the analysis.
- Exposures in other part of the portfolios, for example to businesses dependent on fossil input goods in production and delivery chains, can also constitute both direct and indirect transition risks. In order to be able to draw any conclusions about the total transition risks, the analysis needs to include the insurance undertakings' exposures to firms in sectors other than the private sector as well as other types of securities, such as treasury bonds or banks' covered bonds. [35]
- The analysis is relatively static, and it does not take into account contagion effects or the indirect impact that could be associated with climate-related transition risks.
- The calculations are sensitive to underlying assumptions, for example with regard to technological development.

The outcome that the insurance undertakings' investments are not aligned with the goals of the Paris Agreement is an indication that the carbon-intensive firms that the insurance undertakings are exposed to do not have plans to transition or are transitioning too slowly. Insurance undertakings therefore may need to have an active dialogue with these firms about their transition plans in order to better understand the transition risks and how they should be managed.

35Treasury bonds and covered bonds comprise 76 per cent of the life insurance undertakings' interest-bearing assets and 59 per cent of the non-life insurance undertakings' interest-bearing assets.

Appendix 2. Financial firms' measurement and reporting of climate risks and climate impact – result from FI's survey

As part of the assignment given to FI in 2020, FI has reviewed how far the Swedish financial firms have come in their work to measure and disclose climate risks and climate impact. In the autumn, FI sent a survey to the majority of insurance firms and a selection of large banks, fund management companies and investment firms. In all, 10 banks, 15 fund management companies and investment firms, and 108 insurance undertakings answered the survey. FI reports below in aggregate the responses from the firms.

The survey responses show that many of the firms are working to assess how climate risks and the climate impact should be measured, managed and reported. Many also state that they intend to develop their work further. Only a few of the respondents say that they have processes in place for the entire chain of work to identify, measure, assess, and manage climate risks. Many have processes for identifying risks while fewer have processes for measuring them. The financial firms that have begun measuring the scope of the risks mention a number of analysis tools that they use, such as PACTA, Trucost and Beyond Ratings. The financial firms list the lack of tools and data as key reasons for why they have not come further, although some say that they do not have the resources or that it is not a business priority. And a few make the assessment that they have limited or no exposure to climate-related risks.

More than half of the respondents say that they assess the climate-related risks in their portfolios and in specific exposures, but the risks included in this analysis differ. Firms in all categories report that they assess physical risks based on natural hazard losses and extreme weather events. For example, the banks in question say that they assess physical risks in their credit exposures (for example mortgages and lending to agriculture). When it comes to transition risks, many focus on risks arising from stricter climate regulation. Banks, fund management companies and investment firms say that they also analyse transition risks in the form of market risks, for example changed consumer behaviour and changed demand, as well as risks associated with technological development. In the analysis of the risks, the financial firms often use both quantitative and qualitative assessments.

When it comes to climate impact, more than half of the respondents say that they assess the carbon emissions in their exposures. However, fewer than half measure how their portfolios align with the climate goals in the Paris Agreement, even if several have plans to do so in the future. Very few of the respondents say that they report the results externally.

In general, disclosure of climate-related information is a topic that engages many firms. The firms say that disclosing information has helped them increase their internal focus on climate risks and raise their requirements on suppliers and the customers they are financing. Voluntary initiatives have also contributed to firms progressing in terms of measuring, understanding and defining climate-related risks and integrating them into their activities. At the same time, the firms say that they need to get even better at measuring and reporting their risks.

The majority of the firms that are subject to the sustainability reporting requirements set out in the Annual Accounts Act use voluntary frameworks and standards, either fully or in part, in their reporting. Many consider this to be necessary to meet the requirements set out in the Annual Accounts Act. Among the insurance undertakings that are not subject to sustainability reporting requirements, only a few voluntarily disclose climate risks and climate impact.

One clear trend is that the TCFD has gone from being one of the most important voluntary recommendations for financial firms to follow in 2018 to being the single most important in 2020. Other standards and recommendations that many firms state that they use are UN PRI, GRI and UN Global Compact. The fund management companies also say that they use in their work the European Commission’s non-binding guidelines on reporting non-financial information.

The firms say that the TCFD recommendations provide good guidance on the information that needs to be disclosed and that they have a good structure. The firms say that since the recommendations are established, this also helps increase transparency and harmonisation.

The respondents highlight a number of challenges when it comes to sustainability reporting. Many perceive that reporting in accordance with the frameworks requires a lot of resources. Several also say that the frameworks are too disparate and that there is no best practice for how to apply them.

The survey responses show that the majority of the firms see a need for measures from the Government and other actors. They consider there to be a need, for example, to harmonise regulations and definitions and for authorities to provide relevant data and models. Some firms also would like to see national frameworks being introduced for measuring and reporting even if they comment that the pending EU regulations should be evaluated first. They also take the position that the Government and authorities should help clarify and harmonise the regulations and initiatives that are currently present in the area of sustainability.

FI has also been given an assignment to analyse how the voluntary sustainability initiative that the banks have committed to contribute to increased transparency and greater integration of sustainability risks in the banks' operations and how transparency around this can be improved. In an analysis from 2018, FI drew the conclusion that the banks are considering sustainability aspects in general, and environmental and climate aspects specifically, more than before in their corporate lending. In general, the view of the banks' work and the general description presented above are in agreement. The banks have made progress but more needs to be done. The majority of the surveyed banks follow both the TCFD and other voluntary sustainability initiatives. They mention several advantages related to them. The most prominent are that the initiatives increase transparency, and that they have increased awareness and contributed to shining a spotlight on climate risks within the organisation. Several banks consider the initiatives gives clear and comprehensive methods for sustainability reporting. In addition to the initiatives having made the banks better at reporting on climate risks, they have also helped the banks become better at measuring, understanding and defining climate risks, and also integrating the risks into their operations.

Banks also mention several challenges related to the voluntary initiatives. For example, they require a lot of work and are resource-intensive. They are often disparate, and there is no best practice for how they should be applied. Small banks also perceive that smaller, local actors have difficulties applying global initiatives. The banks point to a number of areas where continued efforts are required. The banks need to become better at gathering and processing external data and integrating climate risks in existing processes. In order to be able to influence their customers to be more sustainable, the banks also need to be able to better assess how climate risks can impact individual exposures.

FI's overall assessment based on the answers to the survey is that – in general – many initiatives are under way in the industry. This shows that many financial firms are working with these matters. However, in many ways they are still in a start-up phase of their work to integrate climate factors into their activities and disclosures. The financial firms would also like support and guidance in this work when it comes to what should be done and how.

The survey responses show that many financial firms may need to both allocate more resources and increase their competence to handle these matters in an organised manner. Experience shows that new risks that do not have clear definitions and analysis methods can be easily underestimated. If financial firms do not measure the risks, this could mean that they are not aware of the relevant direct and indirect factors that could influence the total risk level in an investment. It might then become apparent subsequently that they have not taken sufficient measures to manage the risks.

The survey responses confirm that the financial firms consider public disclosure to be important from both an internal and an external perspective and that voluntary disclosure initiatives contribute to both greater transparency on and greater awareness about climate risks. Even if it is not possible to draw any comprehensive conclusions, the answers indicate that firms that are not subject to requirements to report climate-related information in many cases do not voluntarily disclose such information. FI considers it to be important that financial firms start to work actively to integrate climate-related factors into their operations, even if they are not obligated to disclose such information. One natural first step in this work could be for firms to systematically identify both climate and sustainability factors in their activities and review how these factors can be integrated into their management of sustainability risks in relevant processes and in their disclosures. It is reasonable that firms adapt their work to the focus and size of their business.

The firms' responses show clearly that voluntary standards and recommendations are important in the firms' work to report in accordance with the rules in effect so far. The rules set out in the Annual Accounts Act only specify at a general level which information firms must disclose. In an analysis from 2018, FI determined that it was often difficult to decipher how financial firms work more concretely with sustainability and climate issues and the real impact their policies in this area have on the operations. The financial firms' descriptions of how sustainability-related risks are identified and managed were in many cases also vague.

FI notes that the financial firms continue to disclose only limited external information on their work with climate and climate risks. The need to develop a best practice and learn from others' experiences to continue to progress in this work is something the firms raised both in their responses and in our dialogues with them. FI therefore held several roundtable discussions during the year to help firms share experiences and learn from one another. This is also an important part of FI's ongoing work with the new EU regulations.

A greater focus on the TCFD recommendations among financial firms could be one way to prepare for the international regulatory changes. Some financial firms also encourage the firms that they are financing to apply the TCFD. In this role, the financial sector has an important opportunity to contribute to the private sector as a whole being at the forefront when it comes to sustainability reporting, and that they already now start to adapt to the international rules on sustainability reporting that are under development.

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