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ALERT MEMORANDUM

UAE's Innovative Climate Risk Principles Expected to Apply to Whole Financial Sector

May 3, 2023

On March 28, 2023, the ADGM's Financial Services Regulatory Authority ("FSRA") and other members of the United Arab Emirates' Sustainable Finance Working Group ("SFWG") launched a public consultation on a new set of draft "Principles for the effective management of climate-related financial risks" by UAE-domiciled financial sector firms (the "Principles").

Stakeholder submissions were sought in the form of feedback to Consultation Paper no. 1 of 2023 by May 1, 2023.

In preparing the Principles, the SFWG[1] took inspiration primarily from the "Principles for the effective management and supervision of climate-related financial risks" adopted by the Basel Committee on Banking Supervision ("BCBS"), and the "Guide for Supervisors Integrating Climate-related and Environmental Risks into Prudential Supervision" published by the Network for Greening the Financial System ("NGFS"). Both standards have their roots in the framework released by the Task Force on Climate-related Financial Disclosures ("TCFD"), a private-sector led task force created within the global Financial Stability Board with the objective of developing common global standards for corporate climate-related disclosures.

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[1] Note that the SFWG is comprised of eleven members, including ministries (Ministry of Finance, Economy, Climate Change and Environment, Office of the UAE's Special Envoy for Climate Change), financial services regulators (the Central Bank, Securities and Commodities Authority, FSRA, Dubai Financial Services Authority) and UAE exchanges (Abu Dhabi Securities Exchange, Dubai Financial Market, and Nasdaq Dubai).

While the TCFD framework mainly concerns climate-related disclosures (with related guidance on risk management within the framework), the SFWG's Principles concern the management of climate-related financial risks specifically. It is against this backdrop that the Principles should be read.

Compared to the BCBS and NGFS standards however, the Principles are intended to potentially "cater for a wider spectrum of financial firms" beyond banking and insurance. Their aim is to set minimum standards for governance and risk management of climate risks for the UAE's financial services sector, although each of the UAE's financial regulators will be free to choose how to adopt and implement the Principles within their own jurisdiction – such as with respect to the time of their entry into force, and the types of firms that will be affected.

The UAE Principles are innovative in the sense that, although voluntary, they aim to cover *all* firms across all parts of the financial sector irrespective of size. This alert memorandum summarizes the Principles and places them within the broader regulatory landscape that has been developing across the EU, the United States, and the Gulf Cooperation Council ("GCC") region. For any inquiries concerning the Principles, or our analysis of the regime's potential future implications for financial firms, please contact one of the authors.

I. Context

TCFD Framework

The TCFD[2] first announced its framework in 2017, comprising mandatory climate-related financial disclosure recommendations for use by companies, banks, and investors in providing information to stakeholders, and divided into four main pillars (governance, strategy, risk management, and metrics and targets.) In 2020, the TCFD supplemented its framework by issuing guidance on the integration of risk management processes into its disclosure framework.[3]

Since then, the TCFD framework has emerged as a *de facto* international benchmark.[4] Presently, the TCFD is leading a survey of asset managers and asset owners on their climate-related financial reporting practices, with a view to revealing aggregated findings in its 2023 status report.[5] We anticipate that these findings will play an informative role in the future development and refinement of the UAE's Principles, given that they propose to also capture asset managers.

Notably, however, no Middle Eastern country has made TCFD reporting mandatory so far and e.g., only a few UAE firms publish climate-related disclosures per the TCFD framework. In October 2022, the TCFD's 2022 status report showed that only about a quarter of all firms in the Middle East and Africa ("MENA") report on their exposure to climate change. MENA represents the lowest ranking globally, followed by Latin America at 28%, North America at 29%, Asia Pacific at 36%, and Europe the leader by far at 60% of all firms making TCFD-compliant disclosures.[6] The TCFD's report also revealed that nearly half of all disclosures were made by companies with a market capitalization above $12.2 billion.

The UAE's Sustainable Finance Efforts

In 2021, the UAE became the first GCC state to announce a net-zero carbon commitment (the "Net Zero by 2050 Strategic Initiative") and in 2023, will become the second Arab state after Egypt to host the UN Climate Change Conference ("COP28"). Also in preparation for COP28, President HH Sheikh

[2] The TCFD was created in 2015 by the Financial Stability Board, a global body that monitors and makes recommendations about the global financial system and whose board comprises all G20 major economies (plus the European Commission).
[3] The TFCD's 2020 guidance paper is accessible here.
[4] Major players in the financial industry have been recently mandated to include climate-risk related disclosures in their annual financial reporting in e.g., the UK, New Zealand, the EU (albeit via its own Corporate Sustainability Reporting Directive), Japan, Brazil (for banks), Singapore (including asset managers).
[5] See the TCFD's website here.
[6] See the TCFD's 2022 status report here.

Mohamed bin Zayed Al Nahyan declared 2023 to be the "Year of Sustainability".

In line with this vision, the UAE published its very first "UAE Sustainable Finance Framework" for 2021-2031. The framework sets out three key pillars: (i) integrating sustainability in financial decision-making and risk management, (ii) enhancing supply & demand for sustainable finance products and (iii) promoting sustainable finance practices and projects generally, beyond the financial sector.

Among the first pillar's objectives is the preparation of standardized guidance on ESG and climate-related reporting and disclosure, in alignment with the TCFD.[7]

The ADGM continues to lay strong foundations for a bridge between technical solutions to the climate crisis and sources of capital to fund those solutions, with a view towards becoming a leading hub in the UAE and beyond for the transformative investments that are urgently required for the carbon-neutral transition.

One step in this direction taken by the ADGM was the development of a sustainable finance regulatory framework, which was consulted on between November 2022 and January 2023. This consultation concerned new rules for green-labelled financial products (investment funds and bonds), and a comply-or-explain ESG disclosure regime for large companies and asset managers based in the ADGM. Cleary Gottlieb took part in this first consultation, with the aim of helping the ADGM refine an ambitious, coherent and business-friendly environment for the development of local green finance. Our analysis of its key provisions its accessible here.

II. Principles for the effective management of climate-related financial risks

The consultation sets out seven Principles to integrate and manage the financial risks arising from climate change, including physical, transition and liability risks. To this effect:

— "Physical risk" refers to potential economic and financial losses from climate and weather-related events and the long-term progressive impact of climate change;

— "Transition risk" refers to the financial risk related to the process of adjustment towards a lower-carbon economy, which can be prompted by, for example, changes in climate policy, technological changes or change in market and social sentiments; and

— "Liability risk" (which is generally treated as a subset of physical and transition) refers to climate-related compensatory claims and direct legal actions (such as emissions lawsuits) that may affect financial firms.[8]

Principle 1: Oversight and board responsibility

Financial firms should develop and maintain an up-to-date "sound climate-related financial risk management framework as part of their overall business strategy". This principle places particular emphasis on the need for board members and senior management to possess appropriate and always updated skills and training for the understanding of climate risk. Their function and ultimate responsibility will be to define and routinely oversee the firm's risk appetite specific to climate.

Principle 2: Incorporation into overall business strategy

The board and senior management should take into consideration all material climate-related financial risks (and opportunities) when preparing and executing the financial firm's overall strategy, and its risk appetite and risk management framework. The periodic review and documentation of climate-related financial risks is thus all the more important.

[7] See UAE Sustainable Finance Framework here.
[8] Cleary Gottlieb closely follows developments related to ESG-related litigation. You can access our white-paper on risks for corporates here, and other articles on specific matters (ranging from emissions lawsuit to board liability) here, under "Sustainability and Dispute Resolution".

Principle 3: Assigning of responsibilities within the organization

Whilst the board remains ultimately responsible for overseeing the management of climate-related financial risks, it should delegate such responsibilities to either board committees or appropriate senior management to help identify, manage, and integrate such risks into the financial firm's business strategy and risk management framework. Firms should consider how best to allocate the responsibilities for managing climate risks, such as by allocating them across the "three lines of defense" (core business, risk function and internal audit). Roles and responsibilities should be clearly defined to ensure sufficient clarity over functions, accountability, governance structure, escalation processes and reporting procedures.

Principle 4: Incorporation into risk management framework

Risk assessment should be conducted using a materiality analysis with clear definitions and thresholds that encompasses both the organization's own physical and transition risk, and the exposure of its clients, counterparties, service providers, and business partners. Risk identification should address different scenarios (such as, typically, a timely versus a late action net zero transition scenario affecting the broader economy), and time horizons (noting climate risks' typically long materialization timeline). Once material risks are identified in this manner, management should establish risk allocation, mitigation and exposure minimization processes, including across subsidiaries, affiliates and international branches. Examples of risk mitigation measures include establishing sectoral or client-specific risk and relationship limits (whether by volume or duration), adjusting client engagement criteria, and applying haircuts to asset values.

Principle 5: Monitoring and reporting

Senior management should establish a system to collect (including with clients), analyze and aggregate climate-related data, and incorporate such information into reporting, monitoring, and escalation processes. Such monitoring should extend, as applicable, to impacts on outsourcing arrangements, service providers, supply chains and business continuity. Firms should identify and make plans to address data gaps, such as by strengthening client engagement on climate-related issues. The frequency of internal reporting should be based on the nature and scale of the risks to which the firm is exposed.

Principle 6: Incorporation into capital and liquidity adequacy processes

Financial firms should consider climate-related risk impact on capital and liquidity positions as part of their internal capital and liquidity adequacy assessment processes. Firms subject to Internal Capital Adequacy Assessment Process, Internal Liquidity Adequacy Assessment Process, Own Risk and Solvency Assessment or similar requirements should include climate-related risk assessment as part of such frameworks.

Principle 7: Scenario analysis

Lastly, financial firms should develop a climate-related stress testing analysis that is appropriate to their size, complexity, activities, and risk profile. The applicable scenarios should include all potential climate-related risks, losses, and vulnerabilities of the firm, across a spectrum of severity (plausible, relevant, severe), risk types (physical, transition, liability) and time horizons (typically short-term for assessing risk profile and business operations, and long-term for business model). Firms will be expected to identify appropriate data inputs and suitable metrics. The results of internal stress tests should be used as an input to analyze the adequacy of the firm's risk management framework from time to time.

III. Comparative remarks and conclusion

Comparative Remarks

Europe

UK and EU regulators were the first to issue guidelines concerning the management of climate-related risk by credit institutions. This was done by the Bank of England's Prudential Regulatory Authority in

2019, and the European Central Bank in 2020, respectively.[9] Since then, both regulators have been periodically supervising firms' integration of their recommendations, and issuing progress reports to flag blind spots and gaps on an aggregate basis.[10] Climate risk management is also partially incorporated in the regulatory requirements set out under the Capital Requirements Directive and the Capital Requirements Regulation, and banks' alignment were reviewed as part of the UK's 2021 biennial exploratory scenario and the EU's 2022 climate stress tests. Similar developments have also more recently started to affect the insurance sector.

United States

The United States is similarly witnessing momentum in climate-related risk management and reporting in the financial sector. Each of the three federal banking regulators – the Federal Reserve Board ("FRB")[11], the Office of the Comptroller of the Currency ("OCC")[12] and the Federal Deposit Insurance Corporation ("FDIC")[13] – have proposed principles for climate-related financial risk management. These principles, which would apply to large financial institutions, have gone through the notice-and-comment process and are awaiting finalization, although the timing on final rules is not clear. In addition, the FRB has launched a pilot climate scenario analysis ("CSA")[14] in which six of the largest U.S. banks are participating. The results of the CSA will not result in supervisory or capital consequences for participating banks; rather, the exercise is intended to be informative for both the FRB and banks. While the U.S. regulatory efforts are not as robust as those of the EU, the trend is likely headed towards increased mandatory climate-related risk assessment and disclosures.

Conclusion

With these comparisons in mind, it is striking that the ADGM's proposal (a) aims to cover *all* financial sector firms broadly, without singling out certain financial institutions such as banks, insurance, and energy companies and (b) without any company size thresholds (which will likely be left to local UAE regulators upon implementation). On the other hand, the Principles are proposed to be voluntary in nature (which also could result in cherry-picking among the Principles). Regardless, the ADGM's Principles may well evolve over time into a mandatory regime as the UAE's Sustainable Finance Framework 2021-2031 and its Net Zero by 2050 Strategic Initiative are approaching and the political appetite for sustainability continues to grow.

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[9] We gave an initial overview of this and other matters relating to climate risk and financial sector supervision in a whitepaper, here.
[10] The ECB's report is accessible here.
[11] See news release here.
[12] See news release here.
[13] See news release here.
[14] See publication here.