JULY 2023

Financial Markets Authority Te Mana Tātai Hokohoko

Scenario analysis in the CRD regime

FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TĀTAI HOKOHOKO

What we will cover

Introduction

What is scenario analysis?

What are the requirements in the CRD framework?

What are our compliance expectations?

What are some common misconceptions?

Questions

The legislation and our role

PRIMARY LEGISLATION

Financial Markets Conduct Act 2013

Part 7A
Climate-related disclosures for certain FMC reporting entities with higher level of public accountability

SECONDARY LEGISLATION

XRB | Te Kāwai Ārahi Pūrongo Mōwaho EXTERNAL REPORTING BOARD

Provides a framework for entities to consider climate-related risks and opportunities. NZ CS 1 →	Outlines a limited number of adoption provisions. NZ CS 2 →	Establishes principles and general requirements. NZ CS 3 →

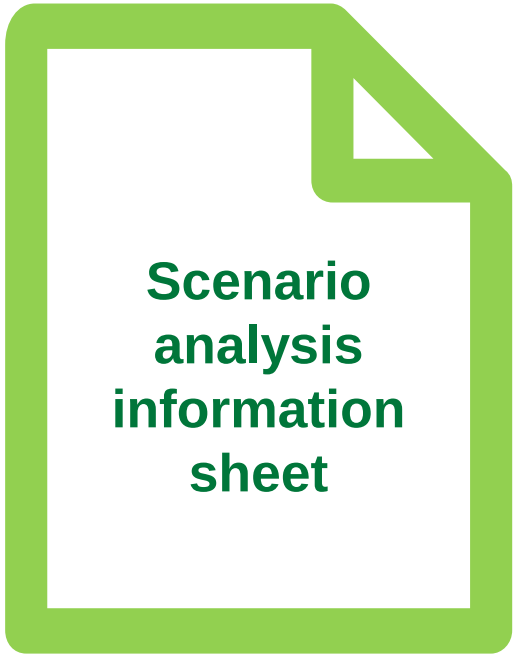
Responsible for the independent monitoring and enforcement of the climate-related disclosures regime

CRD guidance and information sheets from the FMA

Sets out our monitoring and enforcement approach including focus areas

Helps CREs to understand what to look for when engaging third-party providers to deliver services for the regime

Provides the FMAs expectations and key principles for CRD record-keeping obligations



Details compliance expectations for scenario analysis disclosures

What is scenario analysis?

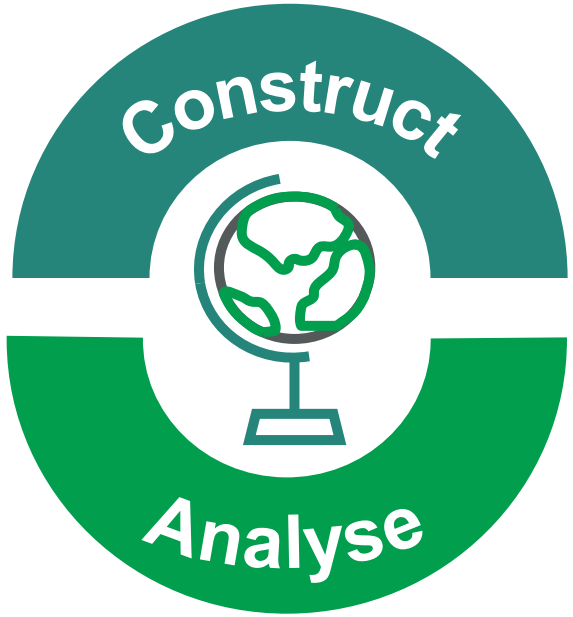
What is the purpose of scenario analysis?

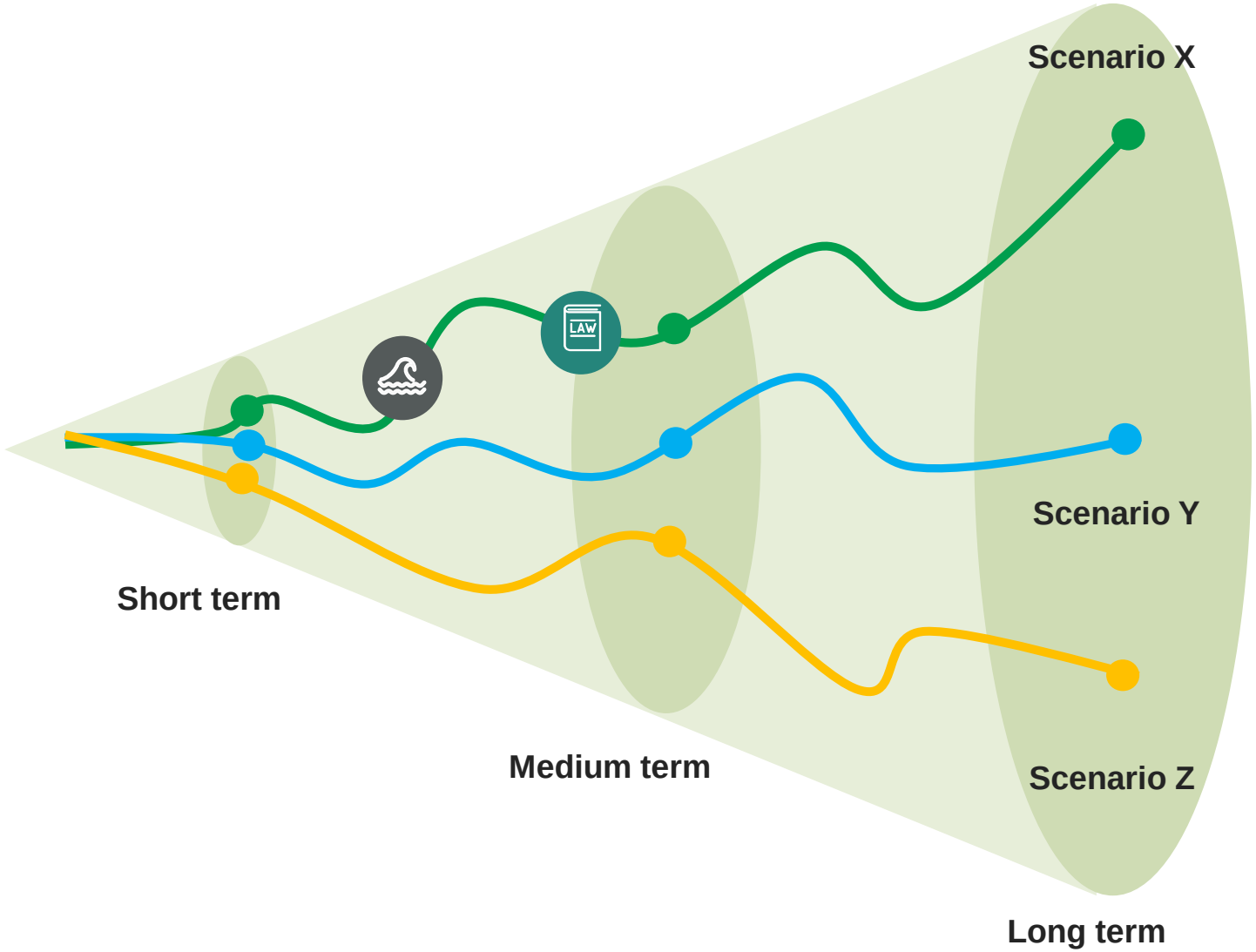
The future impacts of climate change are uncertain and very difficult to predict.

Traditional methods for planning for the future are not appropriate.

Scenario analysis is a **strategic tool** for understanding and exploring how the future may develop under conditions of uncertainty.

What does it involve?





Source: Adapted from XRB

What is a scenario?

Scenarios are:

- Plausible, but hypothetical, descriptions of a series of events (ie **pathway**) leading to a future
- Focused on addressing a particular issue

Scenarios are NOT:

- Forecasts or predictions about what is most likely to happen
- Comprehensive and all-encompassing depictions of the future

What are the requirements in the CRD framework?

Aotearoa New Zealand Climate Standards

NZ CS 1

Paragraph 11(b)

A description of the scenario analysis it has undertaken (see paragraph 13).

NZ CS 3

Paragraph 51

An entity must disclose the methods and assumptions underlying the climate-related scenarios used, and the scenario analysis process employed.

NZ CS 1

Paragraph 13

An entity must describe the scenario analysis it has undertaken to help identify its climate-related risks and opportunities and better understand the resilience of its business model and strategy.

This must include a description of how an entity has analysed, at a minimum, a 1.5 degrees Celsius climate-related scenario, a 3 degrees Celsius or greater climate-related scenario, and a third climate-related scenario (see paragraph 11(b)).

Relationship with other strategy disclosures

Enable primary users to understand how climate change is currently impacting an entity and how it may do so in the future

Scenario analysis could help to inform other strategy disclosures in NZ CS 1

Climate-related risks and opportunities

Para 11(c) / 14 NZ CS 1

Anticipated impacts and financial impacts

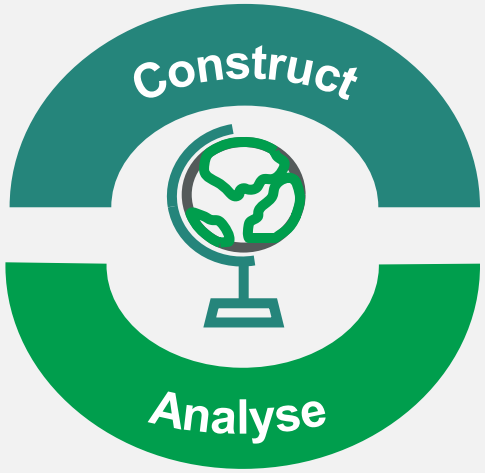
Para 11(d) / 15 NZ CS 1

Transition plan aspects of its strategy

Para 11(e) / 16 NZ CS 1

So, what are the scenario analysis requirements?

Scenario analysis process



Process must comply with definition of '***scenario analysis'*** in the standards

Climate-related scenarios

- **1.5 degrees Celsius**
- **3 degrees Celsius or greater**
- **Third scenario**

Scenarios must comply with definition of '***climate-related scenario***' in the standards

What must be disclosed

Description of the scenario analysis **PROCESS** undertaken

Underlying methods and assumptions

What must be done

Construct climate-related scenarios

Analyse the climate-related scenarios to assess strategic resilience

Produce and retain CRD records to substantiate the **process undertaken** and the **scenarios analysed**

Illustrative example of disclosure

"In March 2023, our board and senior management engaged in a process of scenario analysis. This involved adapting the climate-related scenarios for the general insurance sector in New Zealand. We were involved with developing the sector scenarios as part of our sector group in 2022, facilitated by our industry body XX. Our entity analysed a 1.5°C degree orderly scenario, a 3°C degrees hothouse world scenario, and a second 1.5°C degree disorderly scenario (available HERE).

We added further detail to the sectoral scenarios by making further and different assumptions, particularly more focus on our largest business lines (XX insurance product) and the competitive dynamics within those markets, including the actions and outcomes for the key competitors of strategic interest.

See XX methods and assumptions disclosures below for more detail of the scenarios we analysed. We first had our team construct the scenarios for our specific risks and opportunities and by slightly adapting the sectoral scenarios and adding the assumptions noted above. These were then signed off by the Board. We then engaged a consultant to facilitate five workshops, three with staff from XYZ departments, then two with the Board and senior management whereby the focus was on considering how our business model and strategy would play out in each scenario and options we could take to improve their performance.

We are now conducting transition planning work that is leveraging the learnings from the scenario analysis process and this includes changes to our core business model and strategy."

Source: XRB

What are our compliance expectations?

Scenario analysis process

"A process for systematically exploring the effects of a range of plausible future events under conditions of uncertainty.

Engaging in this process helps an entity to identify its climate-related risks and opportunities and develop a better understanding of the resilience of its business model and strategy."

“Systematically”

Robust, thorough and comprehensive

Follows a logical, methodical and consequential structure

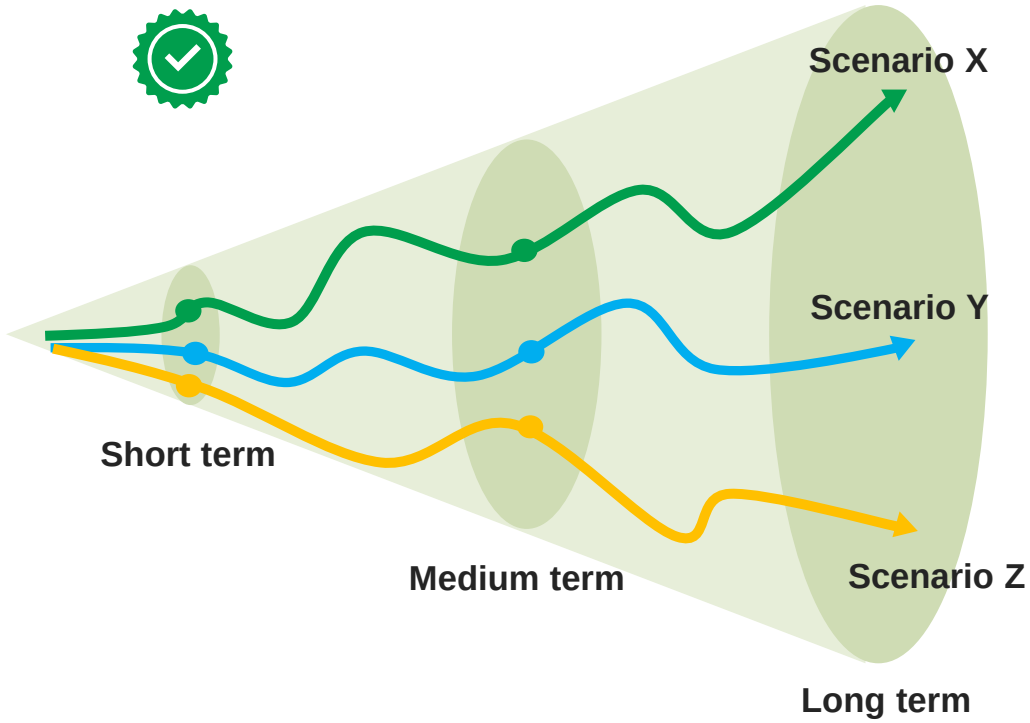
Involve a range of participants

Adopt a broad focal question

Follow accepted practices and methods

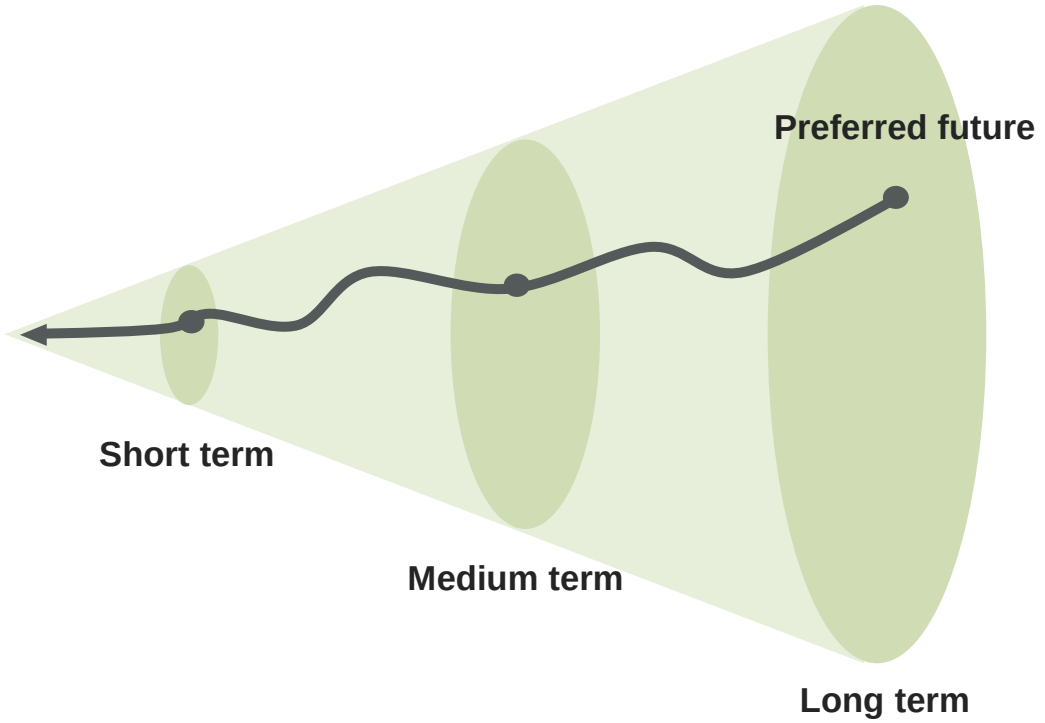
“Under conditions of uncertainty”

Exploratory scenarios



Identify possible risks and opportunities and test strategic resilience

Normative scenarios



Form implementation plans to achieve a desired future

Source: Adapted from TCFD

Climate-related scenarios

1.5 degrees Celsius scenario

3 degrees Celsius or greater scenario

Third scenario

Scenarios must comply with definition of "***climate-related scenario***" in the standards

Brief description of scenario narrative

Definition of climate-related scenario

“A plausible, challenging description of how the future may develop based on a coherent and internally consistent set of assumptions about key driving forces and relationships covering both physical and transition risks in an integrated manner”

Plausible

Challenging

How the future may develop

Coherent & internally consistent

Key driving forces

Physical & transition risks

“How the future may develop”

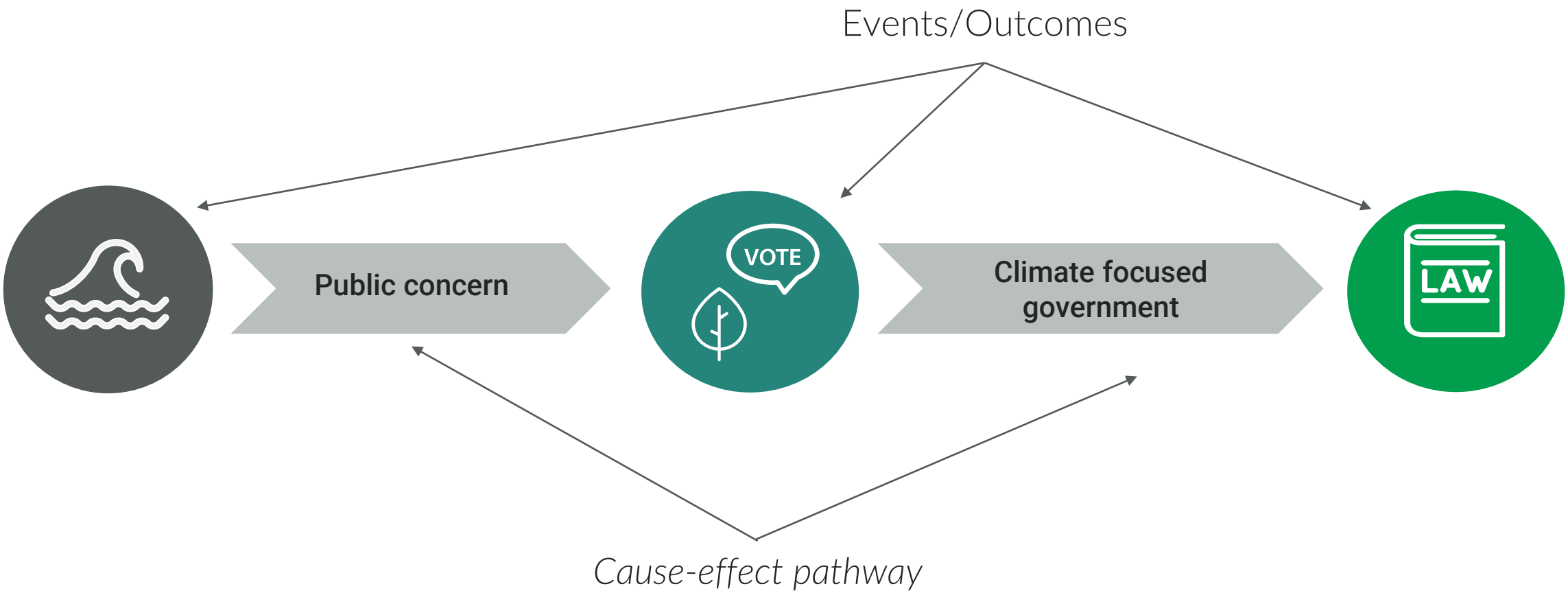
SHOULD

- Describe how events unfold over time
- Join the dots between events that happen
- Demonstrate cause and effect relationships

SHOULD NOT

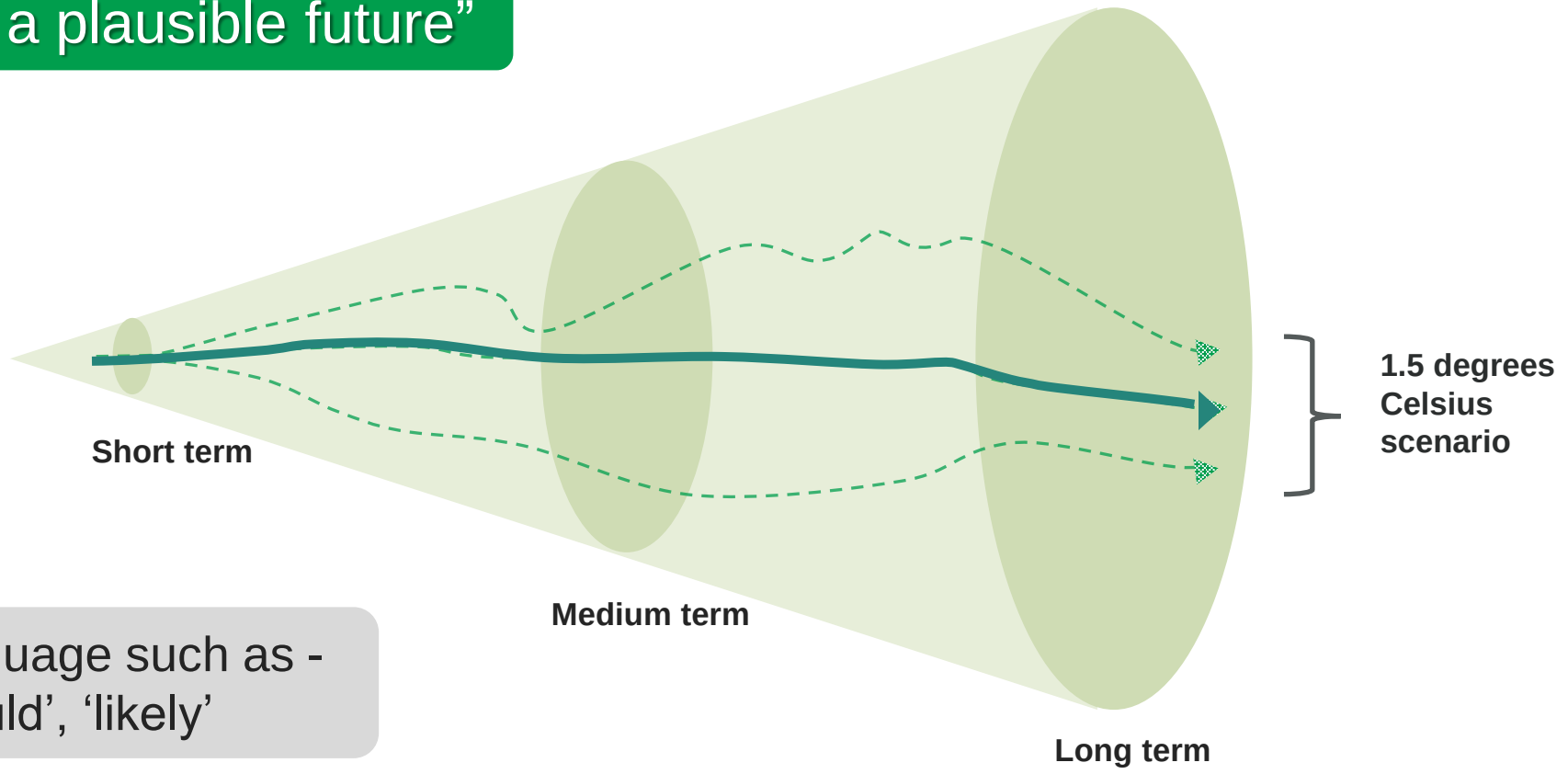
Read as a series of assumptions about a future state

“How the future may develop”



“How the future may develop”

“a pathway to a plausible future”



Avoid language such as - ‘may’, ‘could’, ‘likely’

“Plausible”

Possible, **believable** and **reasonable** within the boundaries of the **temperature outcome** and **overall context**

The ‘colour’ or ‘story’

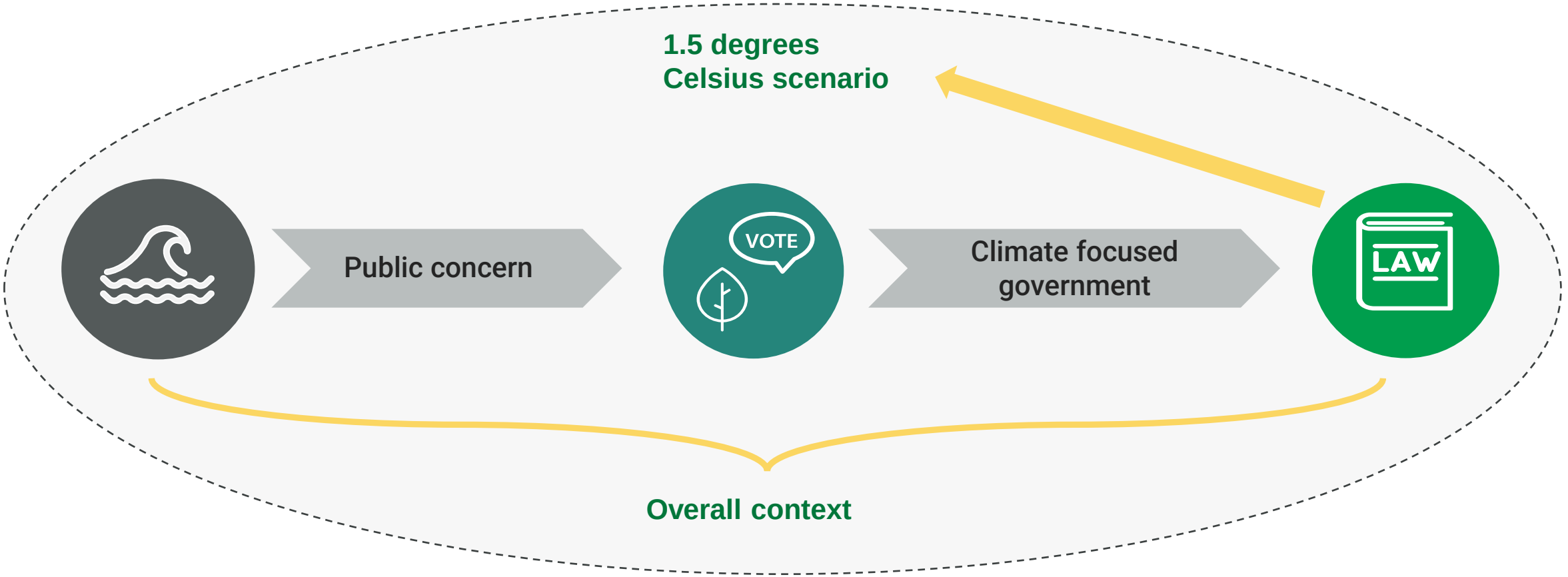
Need to include enough detail in narratives to:

- explain the mechanisms or drivers
- describe the timescales
- explain material impacts

Scenario parameters

Credible scientific and socioeconomic analysis

“Plausible”


1.5 degrees
Celsius scenario
Public concern
VOTE
Climate focused
government
LAW
Overall context

“Challenging”

Think outside the box

Question business as usual assumptions

Confront conventional wisdom

Challenge entities own business model and strategy

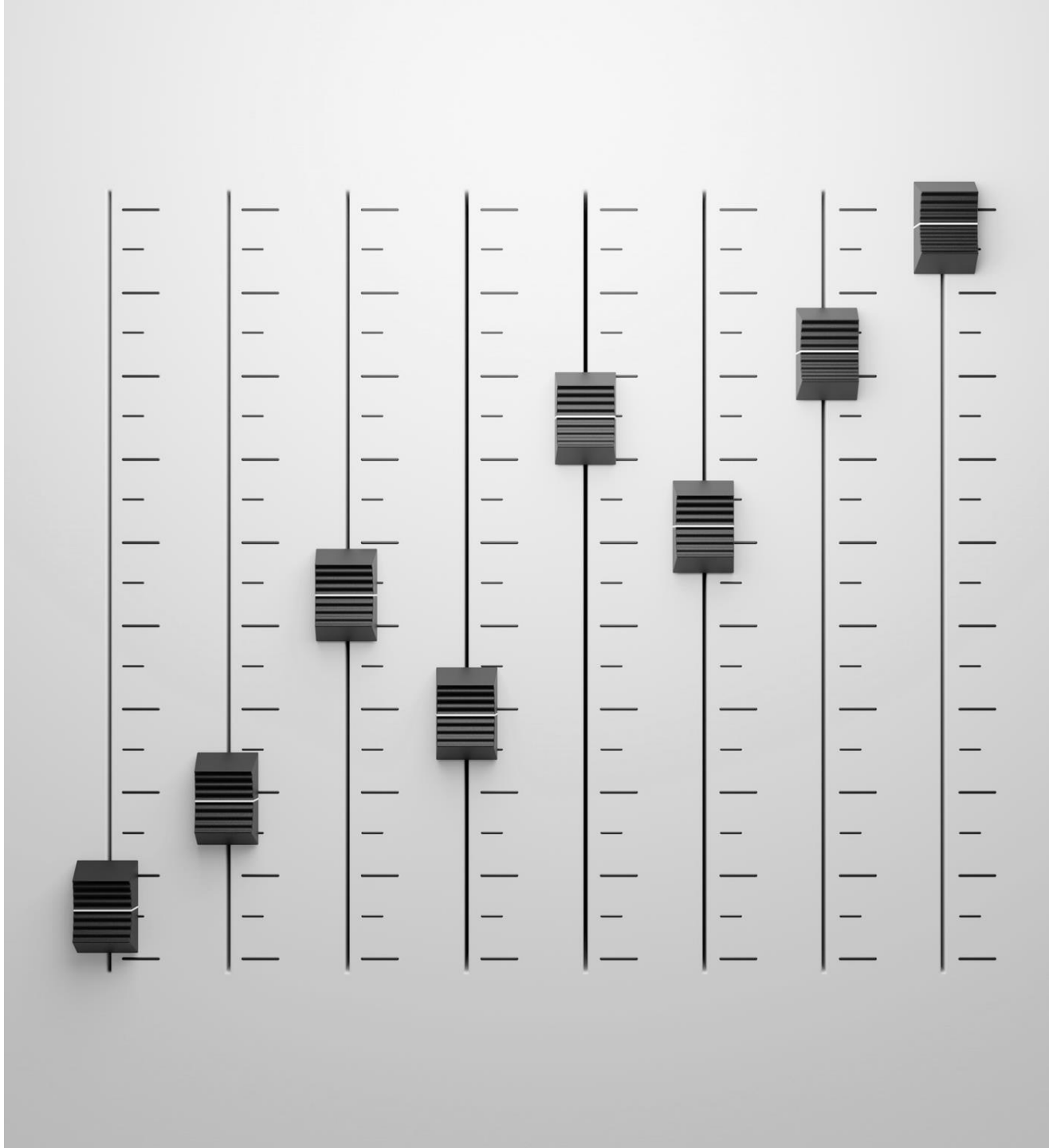
What is considered commonplace and acceptable today ***might*** be looked on very differently in the future.

“Challenging”

A $100 annual fee on ownership of internal combustion vehicles

Or

A total ban on use of ICE vehicles



“Coherent & internally consistent”

Cause and effect

Consequential and logical

Not mutually exclusive

Understand the external information or data used to construct each scenario

“Key driving forces”

External factors

Persistently influence

Social

Demographics, social norms, lifestyle trends, health, education, rural-urban divide

Technology

Research trends, emerging and/or disruptive technologies, technology uptake and market penetration

Economic

Macro and microeconomic policy, trade settings, finance, capital allocation

Environmental

Climate change, biodiversity loss, water, pollution, land use change, waste management, energy

Political

Climate policy, law, regulation, legal liabilities, political attitudes and trends

Source: Adapted from TCFD & XRB

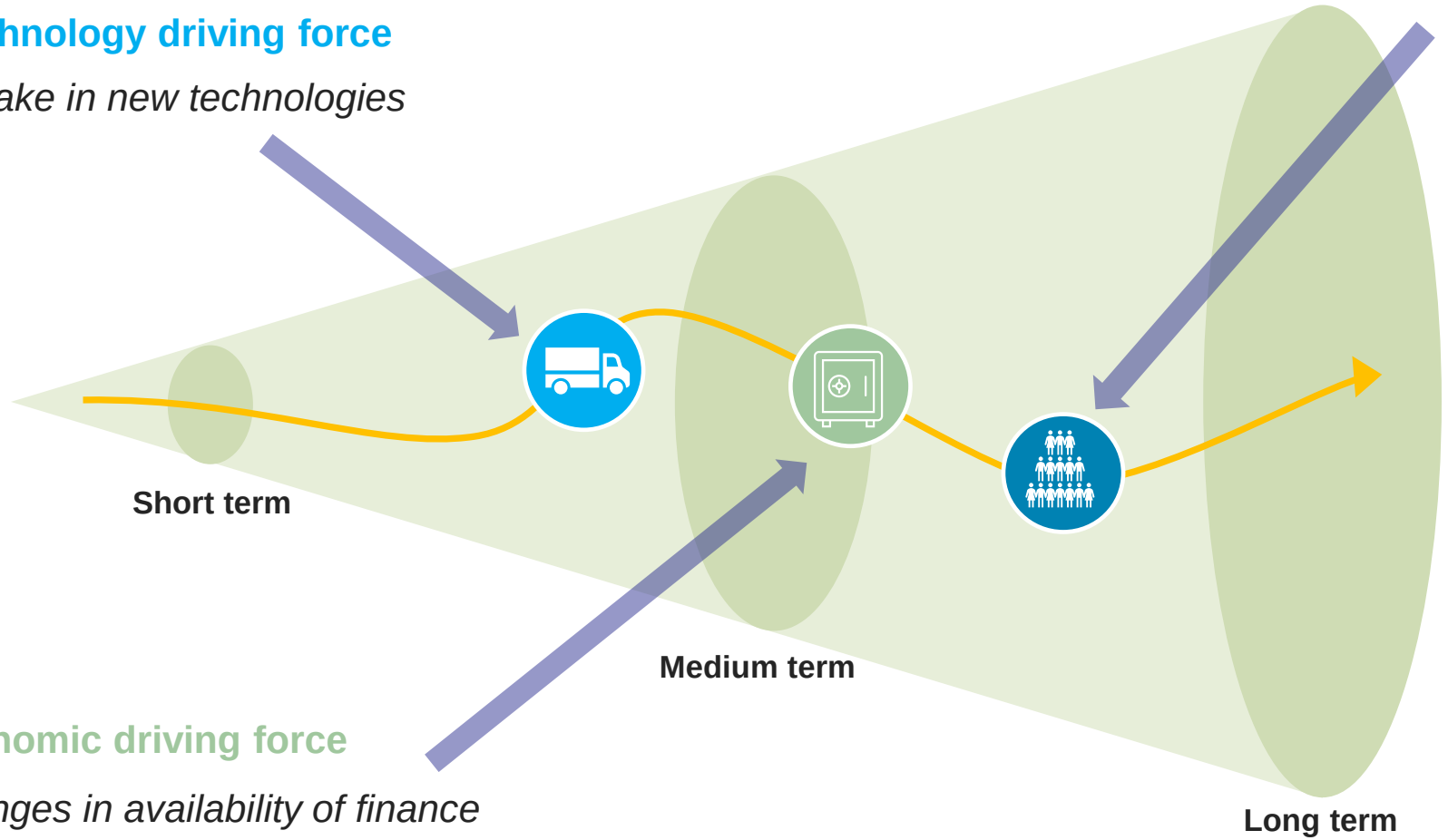
“Key driving forces”

Social driving force

Changes in demographics

Technology driving force

Uptake in new technologies



Economic driving force

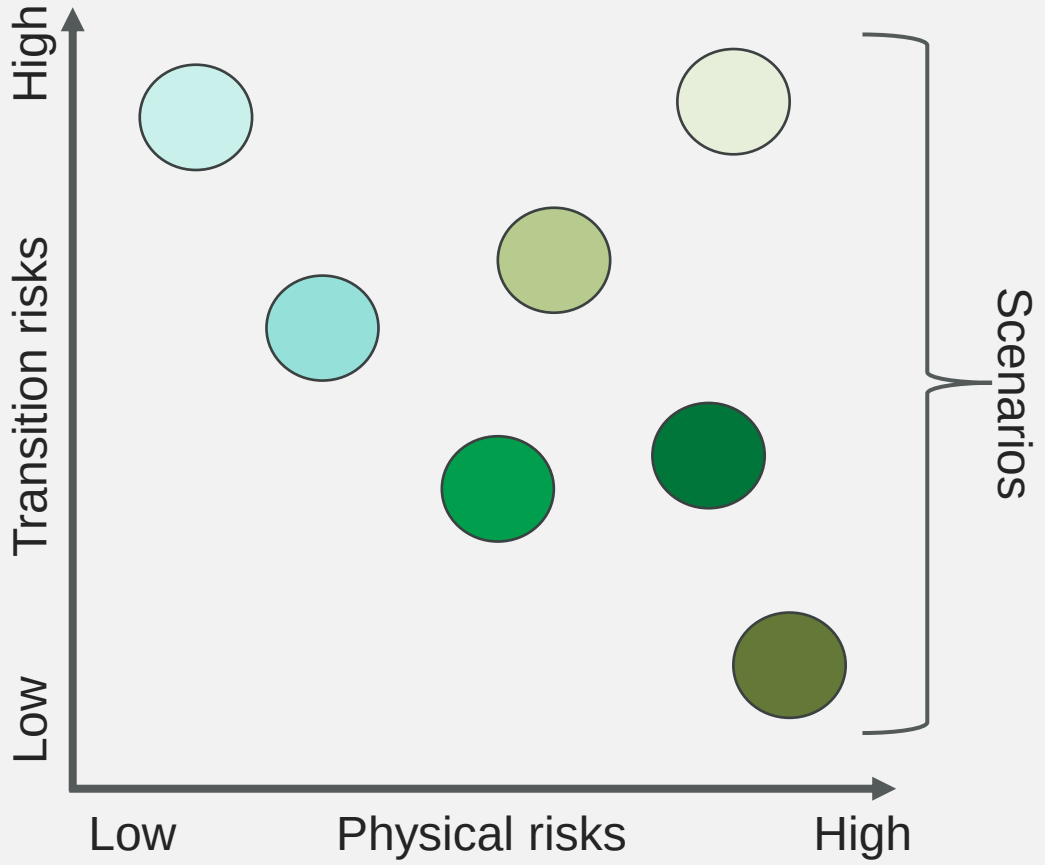
Changes in availability of finance

“Physical and transition risks”

Risks should not be considered in isolation

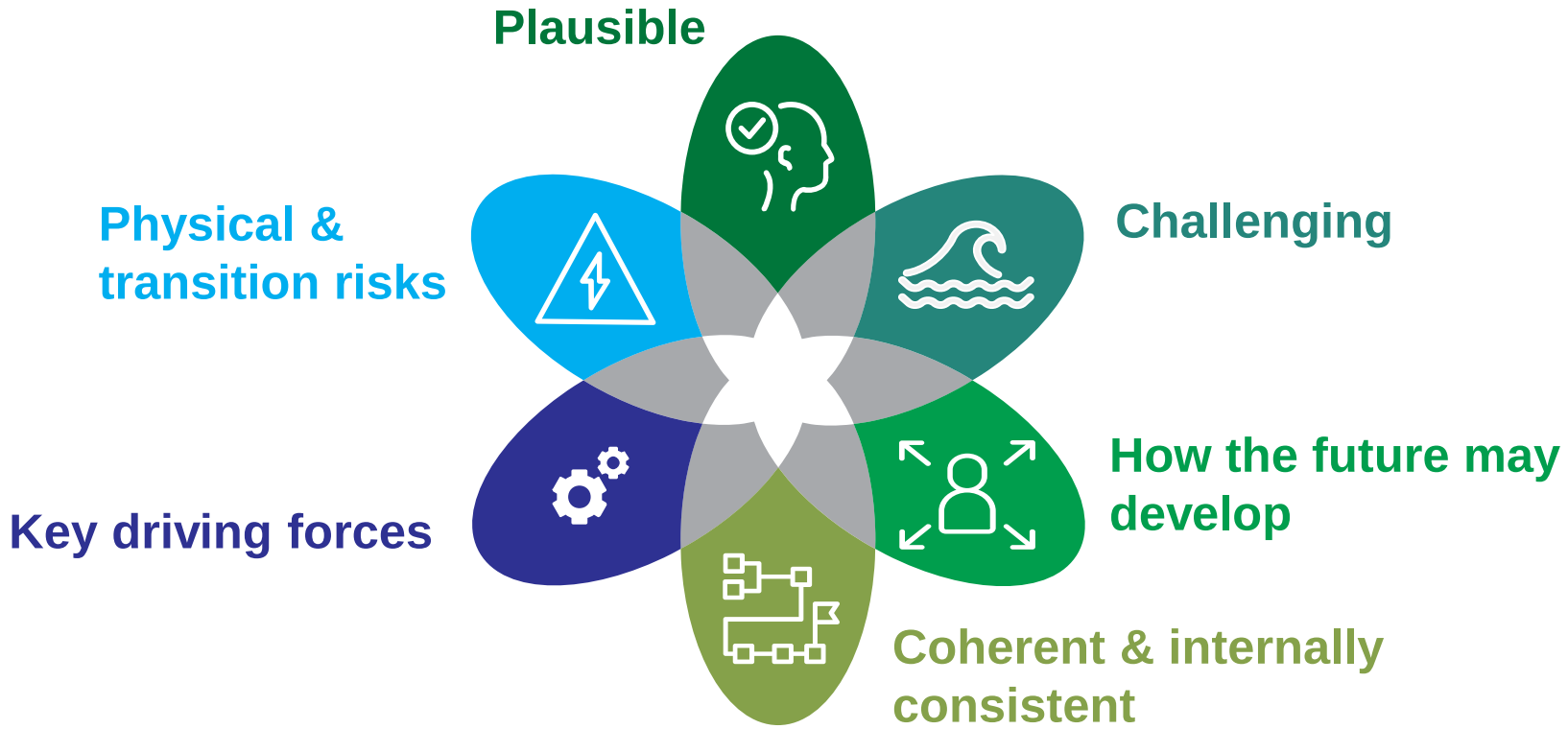
Consider both types of risks in an integrated manner

Consider the interplay between each type of risk



Definition of climate-related scenario

"A plausible, challenging description of how the future may develop based on a coherent and internally consistent set of assumptions about key driving forces and relationships covering both physical and transition risks in an integrated manner"



Relevant to the entity

Identify risks and opportunities and better understand the strategic resilience

Disclose an explanation of why the scenarios are relevant and appropriate

Relevant to the entity's own operations, business model and strategy

- Entity
- Value chain
- Specific characteristics

What are some common misconceptions?

Addressing common misconceptions

Scenarios do not have to be quantified

Scenario analysis is not the same as modelling

Addressing common misconceptions

Scenario analysis is not the same as stress testing

Scenario analysis is not the same as sensitivity analysis

Addressing common misconceptions

Entities need to annually assess whether their scenarios are fit for purpose.

- Meet definition
- Assess resilience
- Identify risks and opportunities

Addressing common misconceptions

Use of sector-level scenarios

Relevant & specific

Revisions

Disclose

Addressing common misconceptions

Comparison of scenario analysis disclosures

1 How robust the scenario analysis process was

Did an entity undertake a more robust process than others?

2 Effectiveness at testing strategic resilience

Are the scenarios constructed more relevant and appropriate to testing strategic resilience of that entity?

Do they meet the definition in NZ CS 1?

3 The degree of influence on the other strategy disclosures

Are the other strategy disclosures more comprehensive?

4 Appropriate core assumptions

Do they align with those commonly used?

Questions?

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