Strengthening the regulatory framework for managing nature-related financial risks

In brief: FINMA has recently published its Circular on nature-related financial risks for banks and insurance companies. Having identified shortcomings in the management of these risks, the regulator intends to codify its practice in this area, thereby strengthening the resilience of the institutions concerned. The Circular will come into force on January 1, 2026, subject to the transitional periods provided for.

I. Introduction

FINMA has repeatedly emphasized the importance of its clients taking climate-related financial risks into account in their business activities.[1] The Circular on nature-related financial risks (Circ.-FINMA 26/1 "Nature-related financial risks") (the "**Circular**") is a continuation of the measures taken to date by FINMA to integrate climate risks (a concept now extended to nature-related risks) into the themes subject to its supervision.

The aim of the new regulation, which codifies FINMA's practice, is to clarify the regulator's expectations regarding the management of nature-related risks. The aim is to promote better application of these principles by the institutions concerned. The implementation of this Circular should also facilitate the collection of data for FINMA's assessment of climate-related financial risks, as provided for in the CO^2 Act.[2]

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II. Key elements

a. Scope of application

For reasons of proportionality, FINMA has chosen to limit the scope of the Circular to banks and insurance companies[3], except for particularly liquid and well-capitalized banks in categories 4 and 5, as well as small insurance companies and reinsurers in categories 4 and 5.

1 See in particular Annual Report 2020, pp. 37 et seq, FINMA Guidance 05/2021 "Preventing and combating greenwashing", November 3, 2021, FINMA Guidance 03/2022 "Implementation of climate-related risk disclosures by category 1-2 institutions", November 29, 2022 and FINMA Guidance 01/2023 "Developments with regard to the management of climate risks", January 24, 2023.

2 See Article 40d of the Federal Act on the Reduction of CO^2 Emissions (CO^2 Act).

3 The Circular applies to (a) banks (Article 1a of the Banking Act, "**BA**"), branches of foreign banks (Article 2 (a) BA) as well as financial groups and financial conglomerates (Article 3c BA) and (b) insurance companies, branches of foreign insurance companies as well as insurance groups and conglomerates (Article 2 (1) (a), (b) and (d) of the Insurance Supervision Act, "**ISA**")

Although the Circular is not directly applicable to other institutions subject to FINMA supervision (*e.g.*, collective or individual asset managers), it is intended to serve as a frame of reference for all those subject to FINMA supervision.

b. Entry into force

The Circular will come into force in stages starting from 2026:

- January 1, 2026: implementation deadline for banks and insurance companies in categories 1 and 2 with regard to climate-related financial risks.
- January 1, 2027: implementation deadline for banks and insurance companies in categories 3, 4 and 5 with regard to climate-related financial risks.
- January 1, 2028: implementation deadline for all nature-related financial risks.

c. Notion of "nature-related financial risk"

The Circular covers the potential negative financial consequences (direct or indirect) to which the institution is exposed because of climate-related risks or other risks related to nature (*e.g.*, risks related to biodiversity loss).

In other words, the Circular aims to manage and reduce the financial risks incurred by the institution itself. On the other hand, it does address the consequences that the institution's activities may have on climate and nature (absence of double materiality). Furthermore, as far as banks are concerned, the Circular does not deal with potential risks to client portfolios arising from nature-related factors.

According to FINMA's approach, nature-related financial risks do not constitute a separate risk category, but rather a parameter to be considered when assessing existing risks (*e.g.*, counterparty risk, credit risk, market risk). They are divided into physical risks (*e.g.*, potential impacts linked to natural disasters or ecosystem degradation) and transition risks (*e.g.*, potential impacts linked to regulatory or behavioral changes).

d. Governance and risk management

The Circular lays down principles in the areas of governance and risk management to enable the integration of nature-related financial risks into the institution's existing processes.

The principles of good corporate governance require the institution to put in place procedures to identify, assess the materiality of, manage and monitor the nature-related financial risks. To this end, the institution must ensure that the relevant bodies and units have the necessary knowledge and experience.

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When assessing materiality, the institution has to take into account any legal and/or reputational risks associated with the identified risk. During this assessment phase, the institution carries out scenario analyses to evaluate the impact of the assumptions made. This process of identifying potential risks and assessing their materiality must be duly documented. This process is also subject to regular review, the frequency of which depends in particular on the risks identified and the company's strategic planning.

The management and monitoring of nature-related financial risks must be integrated into the institution's risk management procedures and its internal control system. Where possible and appropriate, risk indicators with warning thresholds or limits are defined to monitor identified risks.

To prevent legal and reputational risks (particularly from the point of view of greenwashing), the Circular also lays down the obligation to regularly verify that the institution's sustainability declarations are in line with its internal procedures and its strategy for managing nature-related financial risks.

In addition to the above general principles, the Circular contains special provisions for banks and, respectively, insurance companies. For instance, these provisions contain guidelines on how nature-related financial risks can be controlled and mitigated, depending on the type of risk (credit risk, market risk, liquidity risk, *compliance* risk, etc.).

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III. Comments

In line with FINMA's sustainability approach to date, the regulator is focusing its attention on the risks associated with climate change. This risk-based approach is consistent with FINMA's mandate as a financial market supervisory authority.

This new regulation is likely to have an impact on (re)orientating financial flows. Indeed, depending on the institution's risk profile and business strategy, it could be led to set special or more restrictive conditions for clients / policyholders or business partners more exposed nature-related risks.

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