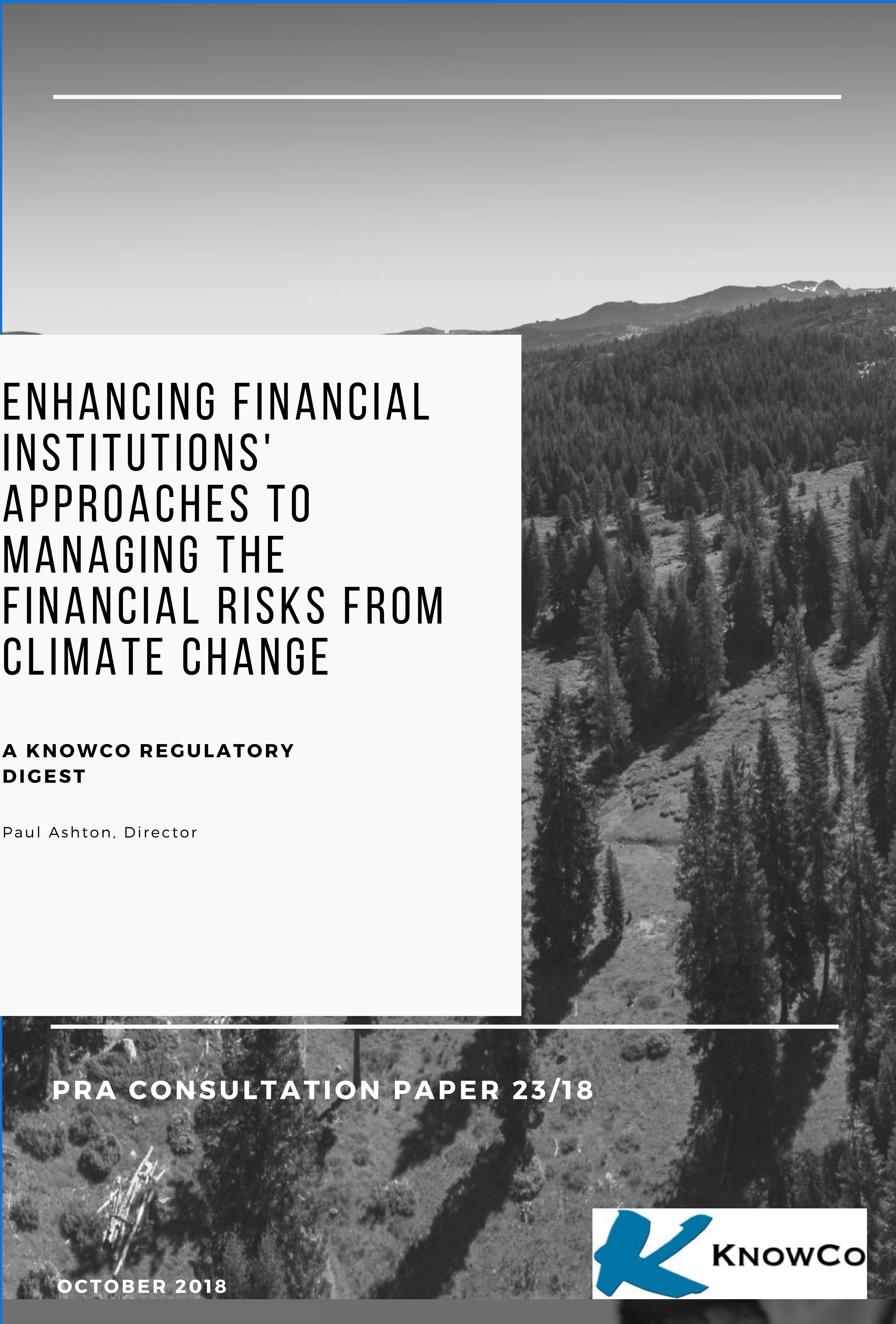

ENHANCING FINANCIAL INSTITUTIONS' APPROACHES TO MANAGING THE FINANCIAL RISKS FROM CLIMATE CHANGE

A KNOWCO REGULATORY DIGEST

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PRA CONSULTATION PAPER 23/18

KnowCo

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THE PRA'S DESIRED OUTCOME

The PRA’s desired outcome is that firms take a strategic approach to managing the financial risks from climate change.

Ensuring consistency of firms’ approaches is also in line with the PRA’s secondary competition objective.

Firms would be expected to identify, measure, monitor, manage, and report on their exposure to these risks.

CONTENT

BACKGROUND & TIMELINE

G20 Paris accord 2015

Subsequent 2017 US withdrawal (as of 2020) 'deplorable' (Merkel)

Remainder of G20 say the accord is 'irreversible'

December 2015: the Financial Stability Board establish the industry-led Task Force on Climate-related Financial Disclosures (TCFD) to design a set of recommendations for 'consistent disclosures that will help financial market participants understand their climate-related risks'.

June 2017: TCFD Final Report issued to FSB

September 2018: PRA report Transition in thinking: The impact of climate change on the UK banking sector

October 2018: Intergovernmental Panel on Climate Change (IPCC) report: warming of 1.5˚C or higher increases the risk associated with long-lasting or irreversible changes, such as the loss of some ecosystems

October 2018 : CP23/18: The PRA's desired outcome is that firms take a strategic approach to managing the financial risks from climate change, taking into account current risks [and] those that can plausibly arise in the future, and identifying the actions required today to mitigate current and future financial risks.

Consultation ends January 15th 2019

GOVERNANCE

In particular, the PRA considers board-level engagement and accountability important to ensure there is adequate oversight of the firm's business strategy and risk appetite.

The PRA would also expect that the board and its sub- committees have clear responsibilites for managing the financial risks from climate change, including individual responsibility (ies) for the relevant existing Senior Management Function holder(s).

The PRA expects a firm's board:

- to understand and assess the financial risks from climate change that affect the firm,
- to be able to address and oversee these risks within the firm's overall business strategy and risk appetite and
- to demonstrate an understanding of the distinctive elements of the financial risk from climate change..beyond standard business planning horizons.

STRATEGY

Firms should include what they determine to be any material exposures relating to the financial risks from climate change in the Internal Capital Adequacy Assessment Process.

Where appropriate, the PRA expects firms to consider a range of quantitative and qualitative tools and metrics to monitor their exposure to financial risks from climate change.

Firms should seek to understand the potential current and future impacts of the physical and transition risk factors on their clients, counterparties, and organisations in which the firm invests or may invest.

To the extent that firms do not have the necessary information, firms are expected to engage with cilents and counterparties where this information is considered material to a firm's own risks.

RISK MANAGEMENT 1

The PRA expects a firm's scenario analysis to address a range of outcomes relating to different transition paths to a low-carbon economy, and a path where no transition occurs. The scenario analysis should, where appropriate, include:

- a short-term assessment which sets out the firm's exposure to the financial risks from climate change within its existing business planning horizon, including, where appropriate, the quantification of these risks; and

- a longer term assessment of the firm's exposure, based on its current business model, of a range of different climate-related scenarios. For example: scenarios based around average global temperature increases consistent with, or in excess of 2°C; and scenarios where the market transition to a low-carbon economy occurs in an orderly manner, or not.

RISK MANAGEMENT 2

Financial risks from climate change arise through two primary channels, or 'risk factors' - physical and transition.

Physical risks from climate change arise from a number of factors, and can be related to specific weather events (such as heatwaves, floods, wildfires and storms) and longer term shifts in climate (such as changes in precipitation and extreme weather variability, sea level rise and rising mean temperatures).

Transition risks can arise from the process of adjustment towards a low-carbon economy. This adjustment is influenced by a range of factors including:

- climate-related developments in policy and regulation, the emergence of disruptive technology or business models, shifting sentiment and societal preferences or evolving evidence, frameworks and legal interpretations.

Some examples include:

- tightening energy efficiency standards for buildings impacting the risk in banks' buy to let lending portfolios

- rapid technological change, such as the development of electric vehicles or renewable technology, affecting the value of financial assets in the automotive and energy sector; and

- companies in the wider economy that fail to mitigate, adapt, or disclose the financial risks from climate change, being exposed to climate-related litigation, which could impact on their market value.

METRICS AND TARGETS

THE PRA WILL EXPECT TO SEE EVIDENCE OF HOW THE FIRM MONITORS AND MANAGES THE FINANCIAL RISKS FROM CLIMATE CHANGE IN LINE WITH ITS RISK APPETITE STATEMENT

The risk appetite statement should include the risk exposure limits and thresholds for the financial risks that the firm is willing to bear, and should take into account factors such as :

- the long-term financial interests of the firm, and how decisions today affect future financial risks;

- the results of stress and scenario testing, for shorter and longer time horizons;

- uncertainty around the timing and the channels through which the financial risks from climate change may materialise; and

- sensitivity of the balance sheet to changes in key risk drivers and external conditions.

Where appropriated, the PRA expects firms to consider a range of quantitative and qualitative tools and metrics to monitor their exposure to financial risks from climate change.

Firms should also use these metrics to monitor progress against their overall business strategy and risk appetite.

DISCLOSURE

Firms have existing requirements to disclose information on material risks with their Pillar 3 disclosures, and on principal risks and uncertainties in their Strategic Report.

All firms within the scope of this SS should consider the relevance of disclosing how climate-related financial risks are integrated inot governance and risk management processes.

The PRA expects firms to engage with wider initiatives on climate-related financial disclosures and to take into account the benefits of disclosures which are comparable across firms, for example the 'Recommendations of the Taskfoce on Climate-related Financial Disclosure' published in June 2017.

WHAT HAPPENS NEXT

KnowCo is preparing an analysis of the TCFD Climate-related Risks and Opportunities, and the detailed guidance and recommendations for Governance, Strategy, Risk Management, Metrics and Targets and Disclosures.

We will further assess any changes to the draft Supervisory Statement when it is finalised.

If you would like to be updated on this work, please let us know.

A DEEPER RELATIONSHIP

KnowCo is a long term, dedicated GRC support partner for UK banks, building societies and other financial institutions. Since our foundation in 2010, we have served more than 40 UK institutions in assignments including:

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- ILAAP
- RRP
- AML & Financial Crime Risk Assessment
- IFRS 9 adoption and implementation
- Credit Risk Modelling
- Risk Appetite Statements
- Business and Strategic Planning
- Stress-testing:
    - Liquidity
    - IRRBB
    - Credit Risk Capital (Pillars 1 and 2A)

KNOWCO'S FIRST IFRS 9 CLIENT HAS BEEN USING OUR SOFTWARE AND CONSULTING SERVICES SINCE 2011

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