PRA POLICY STATEMENT PS11/19 AND SUPERVISORY STATEMENT SS3/19

Enhancing banks' approaches to managing the financial risks from climate change

KnowCo

INTRODUCTION

This digest presents the key points under 4 headings:

1 Antecedents
2. Governance (including Senior Managers & Certification Regime – SMCR – requirements)
3. Risk Management (including Risk Measurement)
4. Disclosure

ANTECEDENTS

- The UK Prudential Regulation Authority and the UK Financial Conduct Authority (PRA, FCA) have established the Climate Financial Risk Forum (CFRF) to support the integration of climate-related factors into financial decision making
- The Bank of England/PRA has joined 33 other Central Banks and Supervisors such as Banco de España, Bank al Maghrib, Banque de France/ACPR, the Bundesbank, De Nederlandshe Bank, the European Central Bank, the Reserve Bank of Australia, the People’s Bank of China, Japan FSA and the Monetary Authority of Singapore in the *Network for Greening the Financial System* (NGFS)

    - The PRA‘s Sarah Breeden chairs one of 3 macroprudential NGFS workstreams
    - PRA CP23/18 was published for consultation in October 2018 – see https://www.knowco.co.uk/resources/regulatory-updates/

GOVERNANCE I(INCLUDING SMCR REQUIREMENTS)

- …firms must fully embed the consideration of the financial risks from climate change into their governance framework
- The PRA considers it appropriate to assign an SMF holder to oversee the management of these risks [however] the PRA does not plan to make climate change a Prescribed Responsibility, and is not prescriptive in which individual(s) should be appointed
    - The board and its sub-committees should have clear responsibilities for managing the financial risks from climate change, including individual responsibility for the relevant existing SMF holder
    - The PRA expects firms to provide the board and relevant sub-committees with management information on their exposure to the financial risks from climate change [to] enable the board to discuss, challenge, and take decisions
- The PRA expects firms to have an initial plan in place to address [these] expectations and submit an updated SMF form by October 15th 2019
    - the policy will not be affected in the event that the UK leaves the EU with no implementation period in place

GOVERNANCE II(INCLUDING SMCR REQUIREMENTS)

- The PRA intends to enquire increasingly as to how the pay of senior managers tasked with delivering a major supervisory priority will be affected by their success or failure in that task
- …firms should address the financial risks from climate change through their existing risk management framework, in line with their board-approved risk appetite, while recognising that the nature of financial risks from climate change requires a strategic approach
    - This would include being able to evidence this in the written risk management policy, management information, and board risk reports

- It is also important that firms do not wait to initiate scenario analysis, as this is important in understanding the risks each firm faces from climate change
- As part of the ICAAP firms should include at a minimum:
    - all material exposures relating to the financial risks from climate change; and
    - an assessment of how firms have determined the material exposure(s) in the context of their business

RISK MANAGEMENT I

- 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).
- Some examples of physical risk crystallising include:
    - increasing frequency, severity or volatility of extreme weather events impacting property and casualty insurance; and
    - increasing frequency and severity of flooding leading to physical damage to the value of financial assets or collateral held by banks, such as household and commercial property.

RISK MANAGEMENT II

- **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

RISK MANAGEMENT III

- 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 clients and counterparties where this information is considered material to a firm’s own risks

RISK MANAGEMENT IV

- 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
    - The PRA expects the time horizon of this long-term assessment to be in the order of decades. As with other types of scenario analysis, this is not intended to be a precise forecast, but a qualitative exercise used to inform strategic planning and decision making.

RISK MANAGEMENT V

- 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 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

DISCLOSURE

- The PRA recognises that firms need a period of time to develop an effective approach to disclosure of their climate-related financial risks. However, firms should recognise the increasing possibility that climate disclosures will be mandated in more jurisdictions
    - The PRA is closely following the debate as to whether the Task Force for Climate-related Financial Disclosures (TCFD) recommendations might be made mandatory
    - In the meantime, the PRA encourages firms to engage with well-established disclosure initiatives such as the TCFD
- The PRA encourages firms to make these [disclosures] public as soon as possible [but] does not expect firms to submit the relevant information to supervisors ahead of public disclosure
- Banks have existing requirements to disclose information on material risks within their Pillar 3 disclosures
    - All firms should consider the relevance of disclosing how climate-related financial risks are integrated into governance and risk management processes
    - https://www.fsb-tcfd.org/publications/

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

KNOWCO IS A SPECIALIST UK BANK SUPPORT RESOURCE FOR:

- ICAAP, ILAAP, RRP
- RISK APPETITE STATEMENT DEVELOPMENT AND ENHANCEMENT
- CRR COMPLIANT PILLAR 3 STATEMENTS
- STRATEGIC BUSINESS PLANNING AND MODELLING
- GOVERNANCE POLICIES,PROCESSES, ASSURANCE

OUR INTUITIVE AND TRANSPARENT SOFTWARE FACILITATES COMPLIANCE WITH REGULATORY REQUIREMENTS FOR:

- CREDIT RISK CAPITAL STRESS TESTING AND MANAGEMENT
- IRRBB STRESS TESTING AND MANAGEMENT
- LIQUIDITY RISK STRESS TESTING AND MANAGEMENT
- FUNDS TRANSFER PRICING
- IFRS 9 COMPLIANCE AND REPORTING

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