Financial Services Regulatory Insights

BoE assesses integration of climate risks into capital framework

AT A GLANCE

March 2023

What's new?

- The Bank of England (BoE) published a report on 13 March 2023, updating its approach to the assessment of climate risks within the regulatory capital frameworks for banks and insurers. The BoE's report builds on its 2021 Climate Change Adaptation Report (CCAR) and identifies areas for future work, although it does not propose specific policy changes.
- The report incorporates: the findings from the BoE's 2021 CBES exercise; the PRA's 2022 thematic observations of firms' management of climate risks and its 2022 review of audit reporting for major UK banks; and an international 'Climate & Capital' research conference hosted by the BoE in October 2022.

What does this mean?

- The BoE summarises five main findings in its report, highlighting gaps in the current capital framework, capability gaps in risk management and gaps in the capital regime. The BoE defines 'capability gaps' as difficulties associated with firms' identification and measurement of climate risks, while regime gaps refer to challenges in capturing climate risks due to the design or use of methodologies in the capital framework.
- The report states that existing capability and regime gaps create a challenge for regulators' risk appetite, particularly in relation to the potential size and timing of relatively unquantified risks. The BoE explains that it will take a judgement-based approach to climate-risk related policymaking across the micro and macro-prudential frameworks.
- Another finding is that effective risk-management controls within firms can reduce the quantum of capital required in the future for resilience, but the absence of controls might suggest a greater quantum of capital will be required. The BoE therefore expects regulated firms to embed climate risks into their wider risk management framework, to better manage expected losses and provide greater resilience towards unexpected losses.
- The majority of the BoE's report explores the conceptual issues underlying regime gaps in the regulatory capital framework. It states that the complexity, uncertainty and potential magnitude of climate risks relative to other capital risks creates specific challenges. The BoE expects firms to develop their use of forward-looking tools such as scenario analysis and stress testing.
- The BoE also commits to developing its own stress-testing framework, beyond the longer-term risks posed by climate change to the impact of shorter-term policy changes on financial markets and asset prices.
- In relation to the one-year time horizon currently used to assess regulatory capital requirements for the banking and insurance sectors, the BoE states that any policy change would need to be supported by greater evidence than currently available. The BoE therefore

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proposes to maintain the current approach, while underlining the use of scenario analysis and stress testing tools to capture longer-term risks.

- The report also considers the nature of regime gaps in the current micro and macroprudential capital framework for regulated banks and insurance firms. In relation to the banking sector, the BoE states that the Pillar 2 framework currently represents a more effective tool to address material gaps, given that any adjustment to the Pillar 1 regime would require an internationally agreed approach.
- The BoE highlights the lack of explicit reference to climate risks in the current framework for insurance capital requirements. It therefore commits to reviewing the microprudential capital regime for insurers, focusing on the calibration of the Standard Formula and the capture of climate risks through the matching adjustment.
- In relation to the macroprudential framework for banks and insurance firms, the BoE concludes that further work is needed to identify potential regime gaps and sets out a number of questions that it states should be addressed before specific policy proposals are considered. The BoE states that a key consideration is the impact of potential policy on the wider transition to net zero.

What do firms need to do?

- The report underlines the importance placed by the PRA on firms' appropriate risk management of climate risks as part of their supervisory expectations. This was a message underlined in the PRA's recent statement on its 2023 supervisory priorities.
- Firms should therefore follow up on the key priorities highlighted in the BoE report and address any identified capability gaps, in order to align with the high-quality practices identified in the PRA's previous feedback.
- These include developing in-house risk identification, measurement and monitoring capabilities (covering both the banking and trading books); improving their use of scenario analysis and stress testing, including the development of short and medium-term risk scenarios; and ensuring that they have a robust framework for assessing the capital impacts of climate risks (for example, including climate risks in their expected credit loss allowance).
- Firms should also note the BoE's second finding that increased capital requirements may be needed to address an absence of controls. Given the BoE has highlighted the use of the Pillar 2 regime to capture material climate risks, firms should anticipate the PRA taking action to address significant concerns. Insurance firms should also note the BoE's focus on the calibration of the matching adjustment to capture the impact of climate risks on firms' portfolios.

Next steps

The BoE commits to further work to ensure regulated firms appropriately manage their exposure to climate risks, and to further develop its regulatory framework. The BoE also requests further climate-related research contributions in specific areas across the banking and insurance capital frameworks.

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