Stand out for the right reasons
Financial Services Risk and Regulation

PRA sets out expectations on how banks and insurers should manage climate-related financial risks

HOT TOPIC
April 2019

Highlight

The PRA has issued its final Supervisory Statement on how banks and insurers should manage climate-related risks. It expects board-level engagement and wants firms to appoint a SMF with responsibility for identifying and managing climate-related risks.

Summary

Climate change and the steps society is taking to respond to it present financial risks for banks, insurers and the broader financial system. To manage these risks, the PRA expects firms to take action in specific areas, set out in *SS3/19: Enhancing banks' and insurers' approaches to managing the financial risks from climate change* and *PS11/19*. The PRA wants to see the firms it supervises take a strategic, holistic and long-term approach, considering how climate-related risks might impact all aspects of the risk profile.

Specifically, the PRA expects to see that a firm's board understands and assesses the financial risks from climate change that affect the firm, and is able to address and oversee these risks from within the firm's overall business strategy and risk appetite. The PRA also expects firms to allocate responsibility for identifying and managing financial risks from climate change to the relevant Senior Management Function(s) (SMF(s)) most appropriate within the firm's organisational structure and risk profile. The PRA wants firms to use stress testing and scenario analysis to inform risk identification and understand the short-term and long-term financial risks that climate change presents to their business models. Material exposures to climate risks should be included within the Internal Capital Adequacy Assessment Process (ICAAP) or Own Risk and Solvency Assessment (ORSA).

Financial risks from climate change

The PRA considers that the financial risks from climate change have distinctive characteristics that together present firms unique challenges and need a strategic approach. These characteristics include that they are far-reaching in breadth and magnitude, have uncertain and extended time horizons, are foreseeable, and their significance depends on short-term actions.

These climate-related financial risks can be separated into two categories: transition risks and physical risks:

- Transition risks arise from a transition to a low-carbon economy. Changes in policy, technology and market sentiment may drive changes in the value of assets and liabilities for banks and insurers. Drivers include government policies that increase the price of carbon emissions, as may be emerging in Europe, rapid changes in the transportation market from low carbon fuels and energy storage as is being seen for electric vehicles, and legal liability risks such as those seen in recent climate-related lawsuits.
- Physical risks arise from acute and chronic shifts in climate patterns, which can lead to damage to assets, business disruption, and changes in individuals' health and incomes, driving financial losses and impaired asset values.

For banks these manifest as credit, market and operational risks (including reputational risk). For insurers, these climate-related factors can manifest as both risk to assets and liabilities, as well as operations. For all firms, such risk factors are likely to be relevant to multiple lines of business, sectors and geographies. The PRA is concerned that the full impact of these risks on the financial system may be larger than for other types of risks, and is potentially non-linear, correlated and irreversible.

The PRA therefore wants to see evidence from individual firms that they are working to identify and manage these risks, and in doing so helping to reduce the potential impact on their firm and the wider financial system.

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What does this mean for firms?

Making sure boards are engaged and equipped

The PRA requires that firms embed the consideration of the financial risks from climate change in their governance arrangements.

Boards of directors, with their long-term stewardship duties, are a crucial element in the governance of climate-related risks and opportunities. Firms will need to ensure that their boards have the right knowledge and tools to discharge this duty in relation to climate change and are supported by an appropriate governance structure.

The PRA expects that firms designate clear accountability for climate within the board and subcommittees, ensure that any individuals or committees designated with this accountability are sufficiently qualified or trained in climate risk, and ensure that boards are supplied with a sufficient amount of high-quality, relevant information from senior management. These steps should enable boards to effectively debate and take decisions in a way that is comprehensively informed by climate risk.

Embedding climate into risk management

The PRA also requires that firms incorporate financial risks from climate change into existing risk management practice.

Firms need to start thinking about climate change as a financial risk and embedding it into their existing risk management frameworks, policies and reports. This also means that firms should approach climate risk in the same way that they approach any other financial risk across all three lines of defence. Accordingly, they are expected to identify, measure, monitor, manage and report on exposure to climate risk. Specifically, as part of the ICAAP or ORSA, the PRA expects firms to include at a minimum:

- All material exposures relating to the financial risks from climate change
- An assessment of how the firm has determined the material exposure(s) in the context of their business

The PRA intends to consult on specific risk management issues in future, so firms can expect to see more detail on areas including risk metrics, how to approach gaps in data, and impacts on specific risk categories such as market risk, credit risk and liquidity risk.

Embedding climate within existing risk management practices requires an appropriate governance structure, a good knowledge of the nature of climate risks, and a strategic view of the material climate-related risks to the firm under different scenarios, and tracking of relevant metrics and targets.

Conducting scenario analysis

The PRA has set out an expectation that firms use (long-term) scenario analysis to inform strategy setting and risk assessment and identification.

As set out by the PRA, the nature of climate risk means that a strategic approach is required. Scenario analysis helps organisations develop a range of plausible futures and test the resilience of the organisation's strategy. This allows firms to assess the impact to financial and operational performance and to take appropriate actions to manage risks, reduce losses and protect or enhance revenues. Scenario analysis requires the development of physical and transition risk scenarios, e.g. aligned to 2ºC and 4ºC emission pathways. It also requires plausible evolution paths for the drivers of climate risk, segmentation of firms' portfolios in terms of exposure to climate-related risk drivers with appropriate granularity and supported by climate-relevant data, and analysis of the impact to relevant indicators of financial performance (e.g. capital requirements). To be effective, scenario analysis should be embedded within a governance structure and with support and involvement of relevant parts of firms' organisations.

Properly conducted, scenario analysis should inform climate risk assessment and identification as well as wider business planning. It should also inform strategy setting so that organisations can align their businesses to the adjustment to a climate-impacted and lower carbon operating environment at an appropriate pace, including opportunities. Quantitative and qualitative outputs from scenario analysis can be used to adapt economic risk models to account for the existence of climate-related risks - for example, banks may wish to consider making adjustments to credit risk models based on the outputs from transition risk scenarios. Scenario analysis should also form the bedrock of stress testing. The PRA plans to ask insurers to consider how their businesses would be affected in different physical and transition scenarios as part of a market-wide stress test. Meanwhile, the Bank of England has announced it will explore whether climate change can be part of a future Biennial Exploratory Scenario (BES).

How should firms respond?

The PRA's SS takes immediate effect, so firms should take action now. Assessing the impact of climate-related financial risks and embedding the management of these new risk types can seem daunting. But there are practical actions firms can take to respond to the PRA's expectations. Initial steps to consider include:

- For boards, consider using the *Guiding Principles For Effective Climate Governance on Boards*, established by the World Economic Forum and PwC, to facilitate internal discussions about climate governance.
- Conduct a climate governance review to understand whether existing governance structures are fit for purpose and how they can be made more robust in line with the PRA's supervisory expectations
- Provide climate governance training to the board to equip members to discharge their duties, providing an awareness and understanding of the financial threats and opportunities posed by climate change
- Identify an appropriate SMF(s) to have specific responsibility for identifying and managing climate risks, and making sure that this individual(s) has the appropriate level of support and information required to discharge these responsibilities. The PRA expects firms to submit an updated SMF Form by **15 October 2019**.
- Begin work on scenario analysis to provide a long-term and strategic view of how business models and operations could be impacted by physical and transition risks
- Review and updating risk management frameworks, policies, management information and board risk reports to include consideration of climate risk

PwC is experienced in supporting banks and insurers on climate-related financial risks. We bring together experts in climate change, financial risk, strategy, data and governance to provide firms with holistic support. PwC has a track record providing C-suite and board-level training on climate-related issues and is uniquely placed to provide insights into best practice.

Stand out for the right reasons

Alert

Protect

Adapt

Repair

Financial services risk and regulation is an opportunity

At PwC we work with you to embrace change in a way that delivers value to your customers, and long-term growth and profits for your business. With our help, you won't just avoid potential problems, you'll also get ahead.

We support you in four key areas

- By alerting you to financial and regulatory risks we help you to understand the position you're in and how to comply with regulations. You can then turn risk and regulation to your advantage.
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- Adapting your business to achieve cultural change is right for your customers and your people. By equipping you with the insights and tools you need, we will help transform your business and turn uncertainty into opportunity.
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