

Policy Statement | PS11/19

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

April 2019



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PRUDENTIAL REGULATION
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1 Overview

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) provides feedback to responses to Consultation Paper (CP) 23/18 'Enhancing banks' and insurers' approaches to managing the financial risks from climate change'.¹ It also contains the final Supervisory Statement (SS) 3/19 'Enhancing banks' and insurers' approaches to managing the financial risks from climate change' (Appendix).

1.2 This PS is relevant to all UK insurance and reinsurance firms and groups, ie those within the scope of Solvency II including the Society of Lloyd's and managing agents ('Solvency II firms') and non-Solvency II firms, (collectively referred to as 'insurers'), banks, building societies, and PRA-designated investment firms (collectively referred to as 'banks'). 'Firms' will be used to refer to both insurers and banks.

Background

1.3 In CP23/18 the PRA sought views on a draft SS on banks' and insurers' approaches to managing the financial risks from climate change. The draft SS set out proposed expectations concerning how firms:

- embed the consideration of the financial risks from climate change in their governance arrangements;
- incorporate the financial risks from climate change into existing risk management practice;
- use (long-term) scenario analysis to inform strategy setting, and risk identification and assessment; and
- develop an approach to disclosure on the financial risks from climate change.

Summary of responses

1.4 The PRA received 54 responses to the CP. Respondents generally welcomed the PRA's proposals. Some respondents urged the PRA to move more quickly and decisively on climate change issues. There were also a number of requests for clarification. Feedback to these responses is set out in Chapter 2.

Changes to draft policy

1.5 Following consideration of respondents' comments, the PRA has made the following changes to the expectations in the SS:

- provided more clarity on the timescales appropriate for scenario analysis;
- updated the wording of the disclosure expectations in response to requests for clarification; and
- clarified that financial positions related to climate vulnerable assets cannot always be hedged, so firms should not rely on that assumption.

¹ October 2018, page 2 of 2: <https://www.bankofengland.co.uk/prudential-regulation/publication/2018/enhancing-banks-and-insurers-approaches-to-managing-the-financial-risks-from-climate-change>.

1.6 The PRA does not consider these changes to be significant and, as a result, its CP assessment of the impact on mutuals and its cost benefit analysis are unchanged.

Implementation and next steps

1.7 The expectations in SS3/19 take effect on publication of this PS. The PRA expects firms to have an initial plan in place to address the expectations and submit an updated Senior Management Function (SMF) form by Tuesday 15 October 2019. However, firms should note that expectations on firms and SMF holder(s) will take into consideration the evolving understanding of what best practice looks like.

1.8 The PRA intends to publish more detailed expectations in due course. The PRA considers that firms' practices regarding the financial risks from climate change will continue to develop and mature, and the sophistication of firms' approaches will reflect that. The PRA and Financial Conduct Authority (FCA) have established the Climate Financial Risk Forum (CFRF) to support the integration of climate-related factors into financial decision making, for example by developing analytical tools and techniques. The outputs from the CFRF, supervisory engagement, and the PRA's international work with the Central Banks and Supervisors Network for Greening the Financial System (NGFS) will inform the PRA's approach to supervising these expectations and the PRA will keep its climate change policy under review.

1.9 The policy set out in this PS has been designed in the context of the current UK and EU regulatory framework. The PRA has assessed that the policy will not be affected in the event that the UK leaves the EU with no implementation period in place.

2 Feedback to responses

2.1 The PRA must consider representations that are made to it in accordance with its duty to consult on its general policies and practice, and must publish, in such manner as it thinks fit, responses to the representations.²

2.2 The sections below have been structured broadly along the same lines as the chapters of the CP. The responses have been grouped as follows:

- Governance.
- Risk management.
- Scenario analysis.
- Disclosure.
- Other responses.

Governance

2.3 The PRA proposed that firms fully embed the consideration of the financial risks from climate change into their governance framework. In particular, the board and its sub-committees should have clear responsibilities for managing the financial risks from climate change, including individual responsibility(ies) for the relevant existing SMF holder(s).

² Sections 2L and 2N of FSMA.

2.4 Overall, respondents were supportive of the governance expectations set out in the draft SS. While respondents agreed that there should be clear roles and responsibilities for managing financial risks from climate change, some questioned whether it was too early to assign individual accountability under the Senior Managers Regime, as most SMF holders did not yet have the technical expertise and views on best practice were evolving. Given the unique and unprecedented nature of the financial risks from climate change, the PRA considers it appropriate to assign an SMF holder to oversee the management of these risks. The PRA will therefore maintain the expectation in the SS.

2.5 The PRA understands that firms are building the internal expertise necessary to manage the financial risks from climate change and will therefore need some time to be able to meet these expectations. As a result, the PRA expects the SMF(s) to be responsible initially for ensuring there is a plan in place to address and implement the expectations in the SS. However, the SMF holder(s) will not immediately be held accountable for meeting all expectations. The PRA expects to see the expertise of the assigned SMF(s) develop over time. To ensure SMFs are in place and are able to manage firms' responses to this SS, firms should have identified the individual(s) and submitted relevant forms by Tuesday 15 October 2019. By this point, the PRA expects firms to have a plan in place to meet the expectations in the SS.

2.6 One respondent asked whether responsibility for the financial risks from climate change will become a Prescribed Responsibility. The PRA does not plan to make climate change a Prescribed Responsibility.³

2.7 There were also requests for guidance on which individual(s) to appoint as relevant SMF holder(s), and whether they should be first or second-line of defence. Firms' approaches to managing the financial risks from climate change vary, therefore the PRA does not want to be prescriptive in which individual(s) should be appointed the responsible SMF(s). It is for firms to decide the individual(s) most appropriate in their organisation. Therefore, the PRA will not be updating the SS to prescribe who should be the SMF.

2.8 Some respondents asked for more guidance on how to apply the governance expectations. This included whether to link the expectations to remuneration, require specific skills or experts on the board, create a siloed climate change function, assign sub-committee responsibilities, or set a specific frequency of board assessment. The PRA judges that it is for firms to determine the most appropriate way to apply the governance expectations to their business. Therefore, at this time, the PRA does not plan to change the SS to be more prescriptive on the required governance arrangements. However, firms should note that the PRA has said that it 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.⁴ In addition, the PRA considers it unlikely the financial risks from climate change can be managed effectively from a siloed climate change function.

Risk management

2.9 The PRA proposed that firms 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.

³ For more information on Prescribed Responsibilities, please see the PRA Rulebook: <http://www.prulebook.co.uk/>.

⁴ See page 3 of 'Good cop/bad cop' speech by Sam Woods, October 2018: <https://www.bankofengland.co.uk/speech/2018/sam-woods-mansion-house-city-banquet>.

2.10 Overall, respondents were supportive of the risk management expectations set out in the draft SS. In particular, they agreed that firms should address financial risks from climate change through their existing risk management frameworks, and ensure this corresponds to their board-approved risk appetite.

2.11 One respondent asked that the PRA emphasises that financial positions related to climate vulnerable assets cannot always be hedged, so firms should not rely on that assumption. The PRA agrees with this point, but considers this to be similar for other types of financial positions, so will not draw this out specifically in the SS.

2.12 A few respondents requested further guidance on how these expectations should be incorporated within the Internal Capital Adequacy Assessment Process (ICAAP) or Own Risk and Solvency Assessment (ORSA). The PRA is considering this internally and firms can approach their supervisors to develop an appropriate approach to incorporating climate considerations into the ICAAP or ORSA. Therefore, the PRA does not intend to update the SS on this point. As with the other areas of the SS, we expect this to be an iterative process, and approaches to mature over time as methodologies develop.

2.13 Many respondents asked for guidance on a number of issues relating to risk management where the PRA is developing its own thinking. This will be informed by the work of the CFRF, NGFS, and ongoing supervisory engagement. The PRA will therefore not be revising the SS at this stage, but it will aim to consult on more detailed expectations in the future. These issues include:

- what risk metrics and tools should be considered as part of risk management;
- how to approach data gaps;
- impacts on specific risk categories, such as market risk, liquidity risk, credit risk, and how these vary by type of firm; and
- how to manage the implications for banks of some assets becoming uninsurable.

2.14 Other responses requested guidance on the following areas: which balance sheet items are exposed to climate change risks; how frequently the board should review the risk management strategy; and how to respond to climate-related regulation. Given the heterogeneity of firms' business models, the PRA believes it is more appropriate for firms to determine the best approach to risk management in respect of these areas. Therefore, the PRA will not be revising the SS for these points.

Scenario analysis

2.15 The PRA proposed that, where appropriate, firms use scenario analysis to assess the impact of the financial risks from climate change on their current business strategy, and to inform the risk identification process.

2.16 Overall, the responses received on scenario analysis were supportive of the PRA's draft expectations. Some respondents asked that the PRA includes climate change as part of its mandatory stress testing. The PRA sees value in considering climate change as part of its stress testing exercises. As part of a market-wide insurance stress test in 2019, the PRA plans to ask UK insurers to consider how their businesses would be affected in different physical and

transition risks scenarios,⁵ and the Bank of England has announced it will explore whether climate change can be part of a future Biannual Exploratory Scenario (BES).⁶

2.17 Some respondents requested more guidance on the timescales appropriate for conducting long-term scenario analysis. The PRA considers it firms' responsibility to set timescales that are appropriate to assess the long-term risks. For example, timescales could be informed by consideration of public climate scenarios. However, the PRA expects that these timescales would be in the order of decades and has updated the SS to reflect that.

2.18 One respondent noted their concern that scenario analysis could be resource intensive. The PRA is aware that building scenario analysis expertise will require some resource. Initially, the PRA expects that scenario analysis will be exploratory as firms' expertise develops, which should reduce resource costs. However, 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. The PRA encourages firms to make use of existing research and resources relating to different possible scenarios and outcomes to inform their thinking. The SS enables firms to be proportionate in their approach, therefore the PRA does not intend to revise the wording.

2.19 One respondent asked how often scenario analysis should be run. Although it is for firms to decide the appropriate frequency to conduct scenario analysis, the PRA expects it to be on a sufficiently regular basis to ensure the results can feed into the board-approved strategy for managing the financial risks from climate change.

2.20 One respondent noted that it is difficult for general insurers to predict acceptable premium increases as climate costs rise. The PRA understands there are uncertainties when performing long-term risk assessments. It does not intend to update the SS in response to this comment, but advises firms to use scenario analysis to explore different possible futures and inform their approach to increasing risk.

2.21 Many respondents requested further guidance on a number of issues relating to scenario analysis, including:

- requests to develop and publish reference scenarios and key assumptions;
- how to overcome the lack of data; and
- how to build expertise within and outside firms to undertake scenario analysis.

2.22 At this time, the PRA is not in a position to provide further guidance so will not be revising the SS in light of these comments. However, we will aim to do so in the future once we have developed our thinking on these issues; informed by the response to the market-wide insurance stress test, the work of the CFRF and the NGFS, and wider industry engagement.

Disclosure

2.23 The PRA proposed that firms develop and maintain an appropriate approach to disclosure of climate-related financial risks, taking into account not only the interaction with

⁵ See page 7 of 'A new horizon' speech by Mark Carney, March 2019: <https://www.bankofengland.co.uk/speech/2019/mark-carney-speech-at-european-commission-high-level-conference-brussels>.

⁶ See page 46 of 'Transition in thinking: The impact of climate change on the UK banking sector', September 2018: <https://www.bankofengland.co.uk/prudential-regulation/publication/2018/transition-in-thinking-the-impact-of-climate-change-on-the-uk-banking-sector>.

existing categories of risk, but also the distinctive elements of the financial risks arising from climate change.

2.24 The responses to the disclosure expectations were generally supportive. Some respondents stated that the PRA should go further and make climate-related disclosure mandatory. Some respondents noted that climate disclosures should reference opportunities from climate change and be structured in a way that avoids possible litigation risks. Other responses asked for more information about the metrics and targets firms should disclose. In contrast, some respondents stated they needed time to develop useful disclosures, in particular for quantitative aspects.

2.25 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, and prepare accordingly. The PRA is closely following the debate as to whether the Task Force for Climate-related Financial Disclosures (TCFD) recommendations might be made mandatory, for example through the Government's Green Finance Strategy.

2.26 In the meantime, the PRA encourages firms to engage with well-established disclosure initiatives such as the TCFD. The PRA will continue to develop its thinking on what good disclosures look like, utilising its supervisory expertise and informed by the work of the CFRF. The PRA has made a few changes to the SS to clarify, but not substantially change, our expectations.

2.27 One respondent asked the PRA to clarify the distinction between reporting and public disclosure expectations. The disclosure expectations set out in the SS are limited to firms' public disclosures regarding climate change above those already required by Pillar 3 disclosures.

2.28 One respondent suggested that firms should submit climate-related disclosures to the PRA ahead of public disclosure during this period of iteration. Public climate-related disclosures are intended for the market to allow market participants to assess firms' exposure to these risks. Therefore, the PRA encourages firms to make these public as soon as possible and does not expect firms to submit the relevant information to supervisors ahead of public disclosure. However, firms are welcome to discuss wider issues regarding their approach to climate-related disclosure with their supervisors. The SS is therefore not revised in light of this response.

Other responses

2.29 Some respondents stated that the SS was not ambitious enough given the urgency and severity of risks arising from climate change. The PRA expects that the SS will be a catalyst for change among the financial sector. Given the level of expertise currently in the market, these expectations are deemed appropriate at this time; therefore the PRA does not intend to update the SS in this regard. However, as firms' expertise develops and best practice becomes clear, the PRA anticipates it will update its expectations.

2.30 In particular, some respondents urged the PRA to reflect climate-related financial risks in the capital framework. The PRA does not consider that differences in capital treatment for certain types of assets is appropriate at this stage given the lack of a consistent definition of assets with less climate-related risk, and lack of data or other evidence of a risk differential between them. Therefore, it will not be updating the SS to reflect this.

2.31 Some respondents asked for clarification on the implementation timelines and enforcement of the SS. As with other SS, and given the potential impact of the risks, the PRA intends to start supervisory engagement on these expectations from the publication date, as set out in this PS. Supervisory intensity for climate-related financial risks will develop over time as firms' expertise grows. However, we expect firms to show evidence of implementing these expectations in supervisory conversations within a few months of publication.

2.32 A few respondents asked the PRA to define proportionality in respect of the expectations in the SS. It is important to note that the financial risks from climate change can affect all firms, regardless of size. For instance, smaller firms with particular sector or geographical concentrations could be disproportionately affected by the financial risks from climate change. The PRA does not intend to update the wording of the SS, but firms should consider how to meet these expectations in a way that is appropriate for them and can discuss this with their usual supervisory contact.

2.33 Some respondents asked the PRA to clarify whether the SS applies to third-country branches. The SS applies to regulated UK-incorporated entities, and although it does not specifically apply to branches, those firms are welcome to advance these issues within their firm more broadly and can approach their supervisory contact to discuss the expectations if helpful.

2.34 One respondent asked whether the PRA could summarise the SS in a set of questions for firms to consider. Although the PRA does not intend to do this at this time, it sees the value in this proposal and will consider developing this in the future. In the meantime, firms may find it useful to engage with groups such as the World Economic Forum⁷ who have published guiding questions for firms integrating climate-related risks into their business.

2.35 A few respondents asked the PRA to be clearer about the impact of climate change on liability risk. The PRA's report 'The impact of climate change on the UK insurance sector'⁸ identified liability risks as arising from parties who have suffered loss or damage from physical or transition risk factors seeking to recover losses from those they hold responsible. Liability risk, as with credit or underwriting risk, arises from the physical and transition risk channels, rather than being a separate risk channel in itself. The legal risks from climate-related liabilities can be of particular importance to insurance firms given these risks can be transferred through liability protection, such as directors' and officers' and professional indemnity insurance. These points are addressed in the SS, so the PRA does not intend to update the wording.

2.36 One respondent noted the importance of the PRA conferring with other regulators, domestically and internationally, to ensure consistency in particular in relation to disclosure. Another respondent asked that the PRA considers incorporating European policy outcomes into its rulebook. The PRA values coordination with other authorities. For example, it is a founding member of the NGFS, a voluntary group of authorities from across the globe who share best practice for managing the financial risks from climate change. The PRA intends to maintain this level of collaboration going forward, and will be mindful of other international regulatory changes that may be relevant.

2.37 One respondent asked whether the Bank of England is using its power to influence climate change issues beyond financial services. The PRA's remit and the SS only covers the

⁷ <https://www.weforum.org/>.

⁸ September 2015: <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-impact-of-climate-change-on-the-uk-insurance-sector>.

PRA's regulated financial firms and in respect of its statutory objectives. However, it is likely that action taken by financial firms to meet these expectations may encourage other firms to consider the potential effects of climate change.

Appendix

Supervisory Statement 3/19 'Enhancing banks' and insurers' approaches to managing the financial risks from climate change', available at:

[https://www.bankofengland.co.uk/prudential-regulation/publication/2019/enhancing-banks-and-insurers-approaches-to-managing-the-financial-risks-from-climate-change-ss.](https://www.bankofengland.co.uk/prudential-regulation/publication/2019/enhancing-banks-and-insurers-approaches-to-managing-the-financial-risks-from-climate-change-ss)