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UK Finance response to PRA CP 23/18: Enhancing banks' and insurers' approaches to managing the financial risks from climate change

Overview

UK Finance is the collective voice for the banking and finance industry. Representing more than 250 firms across the industry, we act to enhance competitiveness, support customers and facilitate innovation. We welcome the opportunity to respond to the Prudential Regulatory Authority (PRA) consultation paper (CP) 'Enhancing banks' and insurers' approaches to managing the financial risks from climate change' and have also responded to the related Financial Conduct Authority (FCA) discussion paper 'Climate Change and Green Finance' (attached).

We agree that climate change presents significant risks to the environment and society and that these risks have significant economic and financial implications. Government and all sectors of the economy need to work together on this. The imperative for the financial sector is to understand better both the physical and transition-related impacts that could materialise as a result of climate change and assess how they could present financial risks to loan and investment portfolios.

As the CP explains, the draft supervisory statement expands on the PRA's general approach as set out in preceding insurance and banking papers, including 'Transition in thinking: The impact of climate change on the UK banking sector', published on 26 September 2018 in conclusion of the banking sector review. Section 4 of the September paper acknowledges that internationally more than 280 financial firms, including 23 Global Systemically Important Banks (G-SIBs), had endorsed the recommendations of the industry-led Taskforce on Climate-Related Financial Disclosure (TCFD), instigated by the Financial Stability Board (FSB) at the request of G20 Leaders.

The purpose of the CP is to set out the PRA's supervisory expectations in respect of how effective governance, risk management, scenario analysis and disclosure might be applied by firms to address financial risks from climate change. In doing so, it proposes how firms should:

- 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 assessment and identification; and
- develop an approach to disclosure on the financial risks from climate change.

As a framework, this is consistent with the core tenets of the TCFD recommendations since these place governance, strategy and risk management at the heart of an institution's response to climate-related financial risks. Key questions in respect of the expectations as set out in the CP would therefore appear to be around relevance, proportionality and timing given that the understanding of the impact of climate change will develop over time, including how it may impact any individual firm.

Climate-related financial risks continue to be explored in a multitude of fora – most notably for banks and financial services through the UN Environment Finance Initiative (UNEP FI) and the central bank/regulator Network for Greening the Financial System (NGFS). This is in addition to the inter-governmental, regional and national discussions of more general application, with some banks working internally on their own accords. Looking ahead, we see a significant role for the UK Climate Financial Risk Forum being established jointly by the PRA and the FCA. It will be important to ensure that the dialogue within the forum is as open as possible to ensure wide market access to knowledge generated and that its expert membership is fully leveraged. UK Finance would be interested in exploring with the PRA and FCA how it might help with industry consideration of forum topics and the dissemination of ideas generated.

Members look forward to continuing the discussion of supervisory expectations in respect of climate-related financial risks within the context of the overall regulatory agenda.

The PRA's approach to financial risks from climate change

The PRA engaged in considerable outreach during the consultation period and explained as part of this that the draft supervisory statement is intentionally high level and that the PRA considers that it may be in a position to issue more detailed guidance around 12 months after the finalisation of the current statement. While this is in keeping with the common understanding of the nascent stage at which we currently stand on the management of financial risks from climate change, we would underline that in publishing its recommendations in June 2017 the TCFD envisaged a 3 to 5 year timeframe for the development of the core disclosure framework expected to apply to global businesses. Therefore, any further guidance on the part of the PRA should continue to constitute 'work in progress' aligning with the TCFD timeline to ensure that UK supervision fully aligns with the international framework.

• Governance

In the first instance, the PRA is looking to firms to "fully embed the consideration of financial risks from climate change" into their governance framework. The PRA is looking for board-level engagement and accountability and sees this as important to ensuring that there is adequate oversight of the firm's business strategy and risk appetite. It also expects that the board and its sub-committees will have clear responsibilities for managing financial risks from climate change and that this should include individual responsibility(ies) for the relevant existing Senior Management Function (SMF) holder(s).

This, as we understand, would become a supervisory requirement from the publication of the supervisory statement end Q1 2019 and the expectation is that this would form part of the supervisory dialogue and should be built into a firm's ICAAP. Within the consultative dialogue, the PRA provided assurances that it appreciated the formative nature of initial climate-related tools, metrics and processes. The expectation about how firms build this into their ICAAP in the coming years should be non-prescriptive in recognition that firm and regulatory approaches will evolve over time. This needs to be accompanied by tangible development of analytical tools for credit risk and scenario analysis with an appropriate taxonomy and range of metrics. It would be helpful if the PRA could confirm if they agree with this approach.

UK Finance believes that placing responsibility for governance around climate-related risks (and opportunities) within the context of a firm's governance and strategy is a TCFD commitment and larger firms at least are already committed to this. It is entirely natural that within a UK context the PRA would seek to define this in terms of both board oversight of business strategy and risk appetite, including board and sub-committee responsibilities for managing the financial risks from climate change, and the assignment of individual responsibility(ies) for the relevant SMF holder(s). We support this.

Firms are keen, however, that the 'framework' nature of this responsibility in the first instance is acknowledged as expectations are carried forward as part of the supervisory dialogue. It is premature to determine how existing governance structures need to be revised without first assessing how climate change could impact the companies they lend to across and throughout their businesses. There is a real need to ensure that the preliminary nature of the steps now being taken continues to be fully understood and that PRA supervisory teams remain alive to the limited nature of what can be achieved within the immediate timeframe. This, by definition, includes the nature of any individual responsibility under the SMF regime, where the initial assignment of responsibility will necessarily be general in nature. Appreciating this constraint, we would welcome regulatory clarity on the expectations of adding climate change responsibilities to relevant SMFs in the early stages of implementation i.e. before material risks have been identified.

It would seem logical to establish the foundations of governance first, i.e. updating policies, terms of reference, establishing risk reporting etc. and then assigning SMF responsibility once the risks are better understood and a framework in place. As the PRA develops its guidance, it will need consider the differing circumstances of different types of firm, in order that a suitably proportionate approach is established.

In the case of larger overseas banks, which may be impacted by climate change in many different ways across various functions, geographies and business divisions, there are likely to be multiple individuals with responsibility for managing different climate-related impacts. It has further been suggested to us that for some firms materiality might also be a reason for not assigning responsibility for climate-related financial risks to an individual SMF 7 either because the risk is being managed centrally (and not as part of UK operations) or that for some the risk might remain less significant than others. In these instances, it might be appropriate to recognise that responsibility for managing these risks should not be assigned to a single individual, but rather form the responsibilities of various individuals where relevant to their respective businesses.

While our reading of the draft Supervisory Statement is that it accommodates these varying circumstances by referring to "individual responsibility(ies) for the relevant existing Senior Management Function (SMF) holder(s)", it might be helpful to spell out expectations in respect of a variety of firms, including UK branches of overseas firms.

A specific question would be whether the PRA expects responsibility for climate-related financial risks to become a Prescribed Responsibility and, if so, when, taking into account the framework nature of the responsibility and evolution of understanding risks as noted – and bearing in mind the differing position of different types of firm as related above.

• Risk management

The PRA is proposing that firms address the financial risks from climate change through their existing risk management framework, in line with board-approved risk appetite, while recognising that the nature of financial risks from climate change requires a strategic approach. Climate change can lead to a range of different impacts (both physical and transition-related) and it is important to understand (a) what impacts could arise and under what timeframe(s) and (b) how those impacts could drive or influence the types of risks firms must manage.

This is an important perspective to grasp and is illustrated amply in the report published by the Bank on 26 September:

Figure 3.1: Examples of climate-related financial risks to bank's assets

	Credit	Market	Operational
Physical	Increasing flood risk to mortgage portfolios Declining agricultural output increases default rates	Severe weather events lead to re-pricing of sovereign debt	Severe weather events impact business continuity
Transition	Tightening energy efficiency standards impact property exposures Stranded assets impair loan portfolios Disruptive technology leads to auto finance losses	Tightening climate-related policy leads to re-pricing of securities and derivatives	Changing sentiment on climate issues leads to reputational risks

The insight we gain from this is twofold:

- First, the allocation of climate-related financial risks to more traditional risk categories within the risk management framework: credit, market and operational.

- Second, the distinction ‐ as referred to earlier ‐ between more immediate physical risks and transition risks, the latter potentially manifesting themselves over a longer timeframe than that usually considered other than for project finance.

We are supportive of the PRA's thinking that firms should address potential risks driven or influenced by climate change within the scope of their existing risk management frameworks. The need is for firms to "identify, measure, monitor, manage, and report on their exposure to these risks" and to be able to "evidence this in the written risk management policy, management information and board risk reports". We acknowledge that the PRA has signalled that it expects firms to gather and analyse large amounts of climate-related information from clients and other sources and to explore proxies for situations and markets where data is less readily available or is of a poorer quality. The longer term goal, however, must be to place firms in a position where they can assess risk more fully from publicly available information from the companies they do business with. Effective bank disclosure requires effective company disclosure.

We consider this to be entirely in keeping with TCFD commitment providing there is no undue pressure for these written reports to become quantitative in advance of suitable tools and data being available and the evolutionary nature of what we are talking about here continues to be appreciated. This information gathering is essential to informing thinking on risk management. There will also be issues of relevance and proportionality not only for smaller, domestic firms for which the TCFD and the broader climate agenda may have less resonance, but for larger firms in terms of the priority they assign to their gaining an understanding of the risks inherent to different parts of their book – in their first instance those representing 'high carbon' exposures. It would be useful if the PRA could clarify the timelines for when firms are expected to have a mature set of tools and metrics to monitor exposures to climate-related risks and if this aligns with its expectations on when quantitative reports will be required, along with an indication of the level of detail expected in such reports based upon the timeframe and materiality of exposure.

Many banks working on TCFD implementation, including as part of the UNEP FI pilot study, are focused on credit risk. Less attention has so far been given to potential climate-related market risk. The PRA could usefully provide guidance on how climate-related market risk should be considered.

The preliminary nature of the financial risks involved is reflected in the differing views as to whether there should (or should not) be a 'green' discounting factor within the capital regime. The discussion on this is of itself at an early stage with differing views expressed as to whether we might reach the stage where there are objective grounds for an additive discount as opposed to differing risk factors impacting capital through lower probability of default (PD) rates. Green ratings are not an indicator of lower financial risk and we would suggest caution at measures implying that this is the case. We are therefore a very long way away from concluding that climate-related financial risks should form part of a bank's Pillar 1 calculations, and for that matter some years away from considering whether climate-related financial risks should warrant a Pillar 2 charge.

This is illustrated by the example of new Minimum Energy Efficiency Standards given in paragraph 2.10 of the background section. Under new UK Minimum Energy Efficiency Standards. In England and Wales properties with an energy performance certificate (EPC) rating in the lowest two categories (F and G) may no longer be rented under new leases or renewals; similar, but different arrangements are being put in place in Scotland over a 2020-2025 timeframe. It is arguable, however, that paragraph 2.10 overstates the relevance of this since the current standard provides comprehensive exemption where public funding is not available, and liability is capped at a relatively low level under changes planned to be introduced this year. Impact will therefore be limited, though the general point is taken. The example could also be rewritten as a transition risk and opportunity since the spend will reduce future costs and may constitute a lending opportunity, allowing firms to support improved energy efficiency standards.

Firms look forward to further guidance being made available as soon as is practicable. This could include further detail on how to incorporate the risks related to climate change into their ICAAP, including any expectations around reconciling the long term effects of climate change into firms' shorter term planning horizons under Pillar 2. Firms will also need the PRA to indicate how and when stress testing may change to incorporate financial risks from climate change. Given recent announcements by the Bank of England about the potential for climate change risks to from part of its "exploratory scenario" in late 2019, such guidance is particularly timely.

• Scenario analysis

The PRA is fully aware of developments in scenario analysis, while it acknowledges that further progress is required for firms to assess the potential impacts that climate change could have on their business strategy and risk management processes. As the draft supervisory statement explains, the intention would be for the scenarios to address a range of outcomes on the transition to a lower carbon economy and, importantly, potential physical impacts if the world does not meet Paris Agreement targets. The draft statement envisages scenarios, where appropriate, including a shorter and longer term assessment and it is explicitly acknowledged that firms' approaches will develop and mature over time.

We have been pleased to hear recognition from the PRA, during consultation meetings, of the complexity of scenario analysis. This includes the intent of such analysis – for shorter term testing of business plans, for longer term exploration of the implications of climate change, and for the purposes of disclosure as expected by TCFD. Such a range of uses will require a significant evolution in the scenarios which are currently available, and in firms' confidence in utilising these. This will take time and, as acknowledged during the consultation, scenarios must only ever form part of a firms' analytical capabilities on climate change. Industry would welcome the opportunity to work with the PRA to develop expectations about the level of granularity of the scenario analysis, in both the short term and long term scenarios. The needs of smaller firms are likely to differ from larger firms.

We believe the PRA can best support this through the development of exemplar or reference scenarios – particularly through the use of a 'wireframe' scenario aligned to the Paris Agreement goals which can be further populated by firms and used in testing business plans. We see significant merit in consistent disclosure between regulated firms via a reference scenario, which would be another use, supplemented by additional scenarios which might reflect the idiosyncratic or firm-specific risks that have been identified. We recognise, as the PRA does, that not all scenario analysis outcomes will be disclosed.

There is also a coordination role in thinking about disorderly transition scenarios; we note the ESRB Advisory Scientific Committee has undertaken initial work in this regard, but there are currently limited usable 'scenarios' which reflect this outcome . We would welcome the PRA's efforts in supporting further development.

There is also benefit in the sharing of information arising from exploratory dialogues taking place within the UNEP FI, the NGFS and, looking ahead, the UK Climate Financial Risk Forum. These could each be a valuable source of models, case studies and data sets in support of work that firms may undertake in their own right.

- ## Disclosure

UK Finance sees the public disclosure of climate-related financial risks as a lynch pin for effective action on climate change and plans further member discussion in support of this.

The PRA expects that firms will develop and maintain an appropriate approach to disclosure of climate-related financial risks taking into account both the interaction with existing categories of risk and the distinctive elements of the financial risks arising from climate change. As related above, and reflected in the PRA's assessment of the banking sector's response to the challenges posed by the financial risks from climate change in the September report 'Transition in thinking: The impact of climate change on the UK banking sector', for many financial firms this has involved their committing to act upon the recommendations of the TCFD.

Effective integration of climate change considerations by financial institutions also necessitates effective disclosures by the companies with which they do business. There is therefore a dialogue to be had about how best to achieve improvements in the effectiveness of corporate disclosures, accepting that there will also be a need to achieve the right balance of costs and benefits. We would recommend that caution is exercised over legislating a mandatory path forward, without first having a clearer sense of the information that is useful and second having a better idea of the gaps that remain in voluntary disclosures.

Financial firms signed up to the TCFD recommendations have begun the process of reporting on the basis of this model, whether in terms of preliminary statements within their YE2017 Strategic Reports or in terms of expanded information on climate-related risks and opportunities published separately. This includes the largest UK banking groups and several of the larger overseas banking groups with a significant presence in the UK. There is a particular need in respect of these firms for disclosure requirements to be as aligned as closely as possible between differing jurisdictions. An international bank should be able to use consistent methodologies and metrics to report significant perceived risks at a global level (e.g. fossil fuel portfolios in key geographies). In the case of an overseas bank these may not impact the UK entity. It is also important for firm metrics to have a certain level of consistency such that disclosures can be easily compared. The PRA may be well placed to help play a role in ensuring that consistency as metrics are developed.

Smaller domestic institutions in particular are less likely to consider the TCFD (or other international initiatives) to form a relevant reference point in relating information about how they are managed. The draft supervisory statement, however, is right in extending supervisory expectations to these firms, with the PRA needing to balance the costs and benefits when it comes to reporting.

The TCFD recommendations were a good first step in creating a consistent framework to guide climate related disclosures, while providing companies with flexibility to report in a way that best reflects the nature of their business and the materiality of climate change. In acting upon the TCFD recommendations, companies need time to overcome data and forecasting limitations and, as important, to integrate thinking about climate change more systematically into their business processes.

Global harmonisation of climate related disclosures is important. Multiple standards on sustainability reporting will not create comparability or true transparency. UK Finance is supportive in principle of the two-year better alignment project under the Corporate Reporting Dialogue convened by the International Integrated Reporting Council ('IIRC'), which includes many bodies and standard setters .

In terms of data on emissions, there is a risk of double counting across financial institutions. This arises from the fact that allocation of emissions to an individual financial institution's supply chain or exposures is complex and requires information that is not naturally available for the lenders as part of their financing activity. The work of the Science Based Targets Initiative for Financial Institutions . Establishing or using an existing shared-data repository could be investigated.

Impact on mutuals

While the PRA might be right in considering that the impact of its proposals on mutuals should be no different from the impact on other firms, the point made above about relevance and proportionality is likely to apply to mutuals fairly comprehensively given their typically domestic focus. So, for instance, as we look ahead we would expect more of a focus on mortgage-related risks on the part of many mutuals, whether in terms of physical risks e.g. from flood risk or transition risk e.g. from statutory energy efficiency standards.

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