Newsflash

The PRA's publication on climate-related financial risk management and the role of capital requirements

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Last week, the PRA issued their 2021 Climate Change Adaptation Report on the management of climate change risks and their findings in relation to banking and insurance regulatory capital regimes.

There are challenges when using traditional capital-setting approaches (such as those underpinning the current regulatory capital regime) to capture some of the unique aspects of climate risk. This is because using historical data and trends (common with traditional capital-setting approaches) may not be adequate for addressing future climate risks. The PRA raised four key findings from their research, as outlined below:

What were the key findings?

Finding 1: Capital can be used to address the consequences, not the causes, of climate change

The capital framework is not the right tool to address the causes of climate change (greenhouse gas emissions), given that financing and investment decisions would not likely be impacted effectively unless capital held is calibrated at very high levels. However, the capital framework can provide resilience against the financial consequences of climate change by reflecting risks associated with exposures.

Finding 2: Climate-related financial risks are partially captured by current frameworks, but there are gaps

The existing regulatory capital framework has limited scope in capturing the consequences of climate change, which is currently mainly captured through reference to credit ratings and the accounting regime. The PRA identified two main gaps:

- Capability gaps – the industry as a whole is faced with the inability to estimate climate-related financial risks due to a lack of granular data and/or modelling limitations; and
- Regime gaps – there are challenges in capturing climate-related financial risks due to the design of the capital regimes and the methodologies used within them.

Finding 3: Estimating the materiality of these gaps is complex

Identifying and quantifying these gaps requires a forward-looking approach, which can be complex. The PRA highlighted that they need to better understand the materiality of the gaps before they can make any recommendations on a change in the regime. They will likely consider the relevant time horizon for capital in respect to climate change, as well as whether firms should wait for clarification on transition roadmaps, or if action needs to be taken sooner.

Finding 4: More analysis and research is required, including on specific options

The PRA will continue to use the existing prudential framework to mitigate climate-related financial risks until future determinations are made. To aid with this, the PRA will be putting out a "Call for Papers" and host a Climate and Capital Conference in Q4 2022.

Current challenges faced by firms in managing climate-related risks

As part of the report, the PRA noted the main technical areas that firms are finding challenging with regards to climate risk management. These largely fell into the following four categories:

- **Data and disclosures –** the availability of high-quality climate data across the industry and information on climate-related financial risks across the economy remains limited. The majority of firms are yet to publicly disclose information on climate-related financial risks. Even where data is published, the quality of the data may be limited, and it is often difficult to compare information between firms; the use of proxy data and other assumptions is often required to compensate.
- **Scenario analysis –** climate scenario analysis and modelling is novel and presents multiple complexities for firms. The time horizon in which firms are required to model is far beyond what is usually used when considering strategy and risk management. It is noted that constructing the scenarios themselves is the most challenging element, however groups such as the Network for Greening the Financial System (NGFS) have produced a set of scenarios.
- **Risk management –** firms are finding it challenging to formulate a risk appetite statement that accurately reflects firms' appetite for and management of climate-related financial risks. Another challenge is agreeing what metrics should be used for specific elements of their business and how these can meaningfully inform decisions on business strategy.
- **Governance –** data gaps hamper firms' governance processes as firms need to ensure that decision makers are provided with management information that is of sufficient quality and detail. Firms also need to hire or build executive knowledge and capabilities on climate-related risks, and ensure that the board is well equipped for such discussions.

We found these findings to be consistent with the main challenges faced by many of our clients.

Supervisory approach to climate-related financial risks from 2022

From January 2022, the PRA will start to supervise firms against the expectations set out in Supervisory Statement 3/19 for how banks and insurers should enhance their approaches to managing the financial risks from climate change.

It is expected that firms take a forward-looking, strategic, and ambitious approach to implementing the expectations from SS 3/19 on an ongoing basis. As such, the assessment of firms at YE21 will be a checkpoint; firms will be expected to refine and innovate better ways to integrate climate-related financial risk management across their organisation, as the industry's collective understating of climate-related risks, data, tools, and best practice evolves. Expectations will be applied proportionally across firms based on their size, complexity, and exposures to climate-related financial risks.

In addition to the above, from 2022 the PRA will undertake firm-specific work to determine continued progress against its SS 3/19 expectations, including:

- **Assessing firms plans for meeting SS 3/19 expectations –** drawing on firms' internal management information, responses to PRA surveys, and (where applicable) the submission to the 2021 Climate Biennial Exploratory Scenario (CBES) exercise, the PRA will develop assessments of firm's strategies for meeting SS 3/19 expectations.
- **Assurance over firms' approach to climate-related capital adequacy assessments** – the largest firms will need to prepare a short report on how they have embedded the management of climate-related financial risks into their existing risk management frameworks alongside their 2021/22 Internal Capital Adequacy Assessment Process (ICAAP) (for banks) or Own Risk and Solvency Assessment (ORSA) (for insurers). The designated climate change Senior Management Functions (SMF) will be asked to present this assessment to the PRA.
- **Disclosures –** in line with the expectations outlined in SS 3/19 firms are expected to develop appropriate climate-related disclosures. The PRA will look to review disclosures provided after December 2021

Identifying and quantifying gaps in the current insurance regime

In the Climate Change Adaptation report, the PRA noted that there are certain gaps in the current capital regime when used as a tool to consider and manage climate risk. In order to appropriately identify and quantify gaps, some fundamental questions have been raised.

The first is choosing an appropriate time horizon for capital setting in relation to climate change: at present solvency capital requirements are set at a 1-year time horizon, however it is likely that the risks arising from climate change will take many decades to manifest. The time horizon may also need to differ based on exposure or product type, which could prove difficult to develop methodologies for.

The second question focuses on choosing the appropriate scenarios for the identified time horizon. In the UK, the scenarios, as detailed in the CBES exercise, are modelled over the medium- to long-term (i.e. over the next 10-30 years). However, it could be argued that plausible scenarios that see shocks sooner exist. The PRA acknowledged that different regulators around the world have different views on scenarios and defining plausible scenarios will depend on the actions of international governments.

The third question asks how exposed PRA-regulated firms are to these scenarios. Climate scenario exercises will give much more information on exposures than is currently available, but there are limitations posed by CBES scenarios such as losses being spread over the medium- to long-term. This makes it difficult to set short-term capital requirements. Another limitation is the difficulty in capturing feedback loops and second-order impacts, which could increase exposures to climate risk.

The last fundamental question is on the expected impact of non-capital tools. Given that capital is not the only tool available to address these risks, the regulator will consider whether there are other risk mitigation options and how these tools would interact with capital considerations. Rather than changing the regulatory regime, the PRA could make more use of the current capital add-on process.

What‘s coming in 2022?

The PRA will take on further analysis at an international level to understand how regulatory capital frameworks can be improved to better incorporate climate-related financial risks, as currently the full extent of climate-related risk is not being captured. The PRA will explore whether specific changes should be made to the capital calculations. In addition, further analysis will look at the macroprudential and systemic risks related to climate change and how climate elements can more explicitly be implemented into the macroprudential capital regime.

To aid with this, the PRA will be putting out a “Call for Papers” and host a Climate and Capital Conference in Q4 2022. In addition, the Bank will produce a follow-up report on how capital can be used. This will include information on how future scenario exercises might guide work on capital, incorporating learnings from the CBES.

The PRA is intending to go further on this and, by the end of 2022, plans to provide an update on:

- **Regulatory capital** – the PRA will undertake an assessment as to whether changes to the current regulatory capital regime and its implementation are required to address climate-related financial risks.
- **Regulatory returns –** the PRA will consider what regular data supervisors could require from firms and if there is a need to obtain this information via regulatory returns.
- **Scenario analysis** – an update will be provided on the future of climate scenario exercises after the results from the CBES and further lessons from firms’ approaches to scenario analysis have been considered.
- **Transition plans** - many firms have set out transition plans that align their activities with climate targets. These plans will be assessed by the PRA as they will be useful in helping to understand what implications firms’ plans may have on the economy wide transition, and assessing progress on the transition at a firm and system level.

What does this mean for financial services and how can we help?

Our view of the Climate Change Adaptation Report is that the PRA will likely want firms to hold capital for climate risks one way or another, but we believe it will take a few years before consensus is reached on how to do this. The PRA may want to do this through changes to the regulatory regime, for example by changing the 1-year VAR for climate risk specifically, or by capital add-ons proportional for each firm. The PRA have made it clear that they understand this is a significant challenge for both the regulator and the financial services industry, which will require a collaborative effort internationally to agree the best way forward. It is clear there is a lot more the PRA want to investigate, and we expect to find out more following their research conference in 2022.

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Hymans Robertson has a wealth of experience assisting financial firms with building, validating and reassessing capital models, climate-related financial disclosures, and scenario analysis. We are happy to discuss any aspect of capital modelling, climate change and climate-related financial disclosures with you.

If you would like to discuss with one of our specialists, please get in touch.

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