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2021: How to ensure we meet the PRA's Climate Change requirements

In the Dear CEO letter published in July 2020, the PRA set out clearly that firms should have fully implemented their approach to managing climate-related risks by the end of 2021. This means that, by the end of 2021, firms should be able to demonstrate that the expectations set out in SS3/19[1] have been implemented and embedded throughout the organisation.

The PRA has emphasised that while firms should take a proportionate approach that reflects their exposure to climate-related financial risk and the complexity of their operations, it is expected that this approach will develop and mature over time. Some smaller firms will have more complex or concentrated exposures to climate-related risks, therefore the appropriate approach taken must be driven by the business model.

Mark Carney, now the United Nations envoy for climate action and finance, recently suggested that climate change could mean mortality rates equivalent to the Covid-19 crisis every year within thirty years, making it clear that this is an issue that affects life insurers just as much as general insurers.

The Climate Financial Risk Forum (CFRF) guide (CFRF Guide[2]) was published in June 2020. The CFRF was established by the FCA and PRA to help financial firms understand the risks and opportunities that arise from climate change, and provide support for how to integrate them into their risk, strategy and decision-making processes.

The Risk Management chapter of the CFRF Guide has been designed as a guide for those who are working to embed the assessment of the financial risk of climate change into a firm's risk management framework. It sets out some practical guidance on how to address climate risks and describes some good practices. Practical examples and implementation steps are provided under the headings of risk governance, risk management frameworks, risk appetite, risk assessment, data and tools, training and culture, challenges, barriers and gaps. The risk appetite examples provided are useful when establishing the board's top level risk appetite but also at a lower level when setting trigger points. The section on risk assessment focusses on how climate change risk may impact underwriting, credit, market and operational risks, and how these may result in changes to the balance sheet both over the short term and the longer term. The section on financial market risk considers the loss in market value loss due to transition risk which is one area where firms are looking for additional guidance.

The Scenario Analysis chapter provides practical guidance on how to use scenario analysis to assess climate-related financial risks to inform firms' strategy and business decisions. It has been

written to help firms begin their journey of establishing appropriate scenario analyses for their business, as has this recent paper from Crescendo Advisors.

The most advanced firms have started to embed their assessment of climate-related financial risks within their ORSA process by including an explanation of how climate risk is embedded within the risk framework; describing how assets are classified for climate risk; describing the climate scenarios considered and setting out the modelling approaches and assumptions used.

On 16 December 2020, the PRA published an update on the methodology for the climate Biennial Exploratory Scenario (BES). The 2021 BES is intended to build on the climate scenarios included in the 2019 exercise and will not be used to set capital requirements. The intention is that the 2021 exercise will be used by firms as a learning exercise to assist with enhancing their climate change modelling capabilities.

The CFRF Guide summarises the approach which should be taken simply as follows:

- Research climate change.
- Define and operationalise risk appetite.
- Assess impact, processes, data and tools.
- Establish risk mitigation plan.

The PRA's expectations of insurers set out in SS3/19 are categorised under governance, risk management, scenario analysis and disclosure, and we set these out below, together with comments from the recent PRA letter.

Category	Expectation	Dear CEO Letter Comments
Governance	• The Board should understand and assess the financial risks from climate change that affect the firm. • The Board should be able to address and oversee these risks within the firm's overall business strategy and risk appetite. • The firm should be able to provide evidence of how the firm monitors and manages the financial risks from climate change in line with its risk appetite statement. • Firms should have clear roles and responsibilities in managing the financial risks from climate change. This responsibility should be allocated to the most relevant Senior Management Function (SMF).	• Governance structures should be effective in cascading the strategy throughout the firm. • Firms' strategic responses need to be clearer and firms needs to continue developing tools that inform business decisions. • The more advanced firms have provided training for their board to enable them to oversee the risk properly. • The majority of firms have allocated responsibility to an SMF holder and set out the responsibilities in the Statement of Responsibilities. Normally it would be expected that the responsibility would be allocated on one SMF holder.

Risk Management	• The PRA expects firms to address the financial risks from climate change through the firm's existing risk management frameworks, in line with their board-approved risk appetite in a proportionate manner.	• The more advanced firms have mainly completed this although annual reviews are still necessary. • Firms should read the Risk Management chapter of the CFRF guide for more additional advice.
Risk Identification and measurement	• Firms are expected to use scenario analysis and stress testing techniques to identify and measure the impact of the financial risks from climate change on their business model. • Firms' ORSAs should include all material exposure relating to the financial risks from climate change and an assessment of how firms have determined those exposures.	• The analysis and strategies for mitigation of physical risks are more developed than for transitional risks. • The expectation is that firms' assessments are based on qualitative and quantitative evidence and that they develop risk metrics that indicate potential loss. • During 2021, the regulator will be paying particular attention to the metrics and targets that firms are using and how they are incorporated into their risk and governance frameworks. • Firms should use the most appropriate approaches and tools to suit their exposure and business model. • It is recognised that there are some areas where the data is not available to estimate the risks accurately. In these cases, the risk should not be left unrecognised and proxies or assumptions should be used.
		• Risk management tools should be developed to support decision-making and allow firms to monitor their progress against their climate-related risk appetite.

CATEGORY	EXPECTATION	DEAR CEO LETTER COMMENTS
		• Risk management tools should be used appropriately for the speed of change.
Risk Monitoring	• Firms are expected to consider a range of quantitative and qualitative tools and metrics to monitor their exposure to financial risks from climate change and progress against their overall business strategy.	• Firms are expected to have conversations with their clients and counterparties about potential current and future impacts of the physical and transition risk factors. • Firms should start action plans to regularly quantify and mitigate climate risk. • Firms are expected to describe how assets are classified for climate risk, what kinds of scenarios are considered and how detailed they are. • The expectation is that firms describe any modelling approaches and model types used and how risk is being measured, qualitatively or quantitatively. • It is recognised that it is good practice to explain how climate risk is embedded into the risk framework, to understand what climate risk means for balance sheet valuations and to confirm the proportion of the balance sheet evaluated.
Risk Management and Mitigation	• Where the potential impacts of the financial risks from climate change are assessed to be material, the PRA expects firms to evidence how they will mitigate these risks and to have a credible plan or policies in place for managing exposure. • Firms are expected to understand the potential current and future impacts of the physical and transitional risk factors on their clients, counterparties, and organisation in which the firm invests or may invest. • Firms are expected to provide sufficient management information on their exposure to enable the board and relevant sub-committees to discuss, challenge, and take decisions relating to the firm's management of the financial risks from climate change.	

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Scenario Analysis	• Firms are expected to conduct scenario analysis to inform their strategic planning and determine the impact of the financial risks from climate change on their overall risk profile and business strategy. • A firm's scenario analysis is expected to address a range of outcomes, relating to different transition paths to a low-carbon economy, and a path where no transition occurs. • A firm's scenario analysis is expected to include a short term assessment within its existing business planning horizon and a longer term assessment, in the order of decades, under a range of different climate-related scenarios. • Firms are expected to use these scenarios to understand the impact of the financial risks from climate change in their solvency, liquidity and their ability to pay policyholders. Any management actions relied upon to mitigate the risks should be assessed as to whether they are realistic, credible, consistent with regulatory expectations and achievable. • The PRA considers the ORSA to be a useful framework within which to consider the financial risks from climate change.	• Scenario analysis is a key way for all firms to inform their strategic planning and determine the impact on their balance sheet, risk profile and business strategy. • Scenario analysis is for all firms regardless of size, resources and lines of business. Firms that have not started their scenario analysis should start now. • Firms should consider a range of scenarios covering both the short term (business planning horizon) and long term (decades) which are appropriate for their business model. • Scenarios should also cover the full range of climate scenarios and both physical and transition risks. • Firms should consider how quickly their business can react to the changes resulting from the scenario. • Standard tests are available from the PRA BES exercise and the Intergovernmental Panel on Climate Change or the NGFS) • Reverse stresses can be used to identify what could cause a firm to fail and the extent to which this could be driven by climate related factors. • Qualitative results can be informative but should be supplemented by quantitative analysis, even if there is uncertainty in the results.

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Disclosure	• Firms should consider whether further disclosures are necessary to enhance transparency on their approach to managing the financial risks from climate change, in particular how climate-related financial risks are integrated into governance and risk management processes. • Firms are expected to develop and maintain an appropriate approach to disclosure, reflective of the distinctive elements of the financial risks from climate change. • Firms are expected to consider engaging with the Taskforce on Climate-related Financial Disclosures (TCFD) framework and other initiatives in developing their approach to climate-related financial disclosures.	• Firms are encouraged to consult on the guidance available in the CFRF and the TCFD's 2018 and 2019 status reports which set out areas where firms can improve the clarity of their disclosures. • Most of the largest firms have started to produce climate-related disclosures and are making improvements year on year. The majority of firms outside the largest, mostly listed companies have not yet produced disclosures of their climate-related risks. Most have plans to do so but over a long timeframe. Firms who have yet to start are urged to do so.

1. https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2019/ss319.pdf?la=en&hash=7BA9824BAC5FB313F42C00889D4E3A6104881C44
2. The Climate Financial Risk Forum publishes its guide to help the financial industry address climate-related financial risks | Bank of England

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