Managing Financial Climate Change Risks

OUTCOMES FROM OUR INTERNAL AUDIT FINANCIAL SERVICES REVIEW

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Introduction

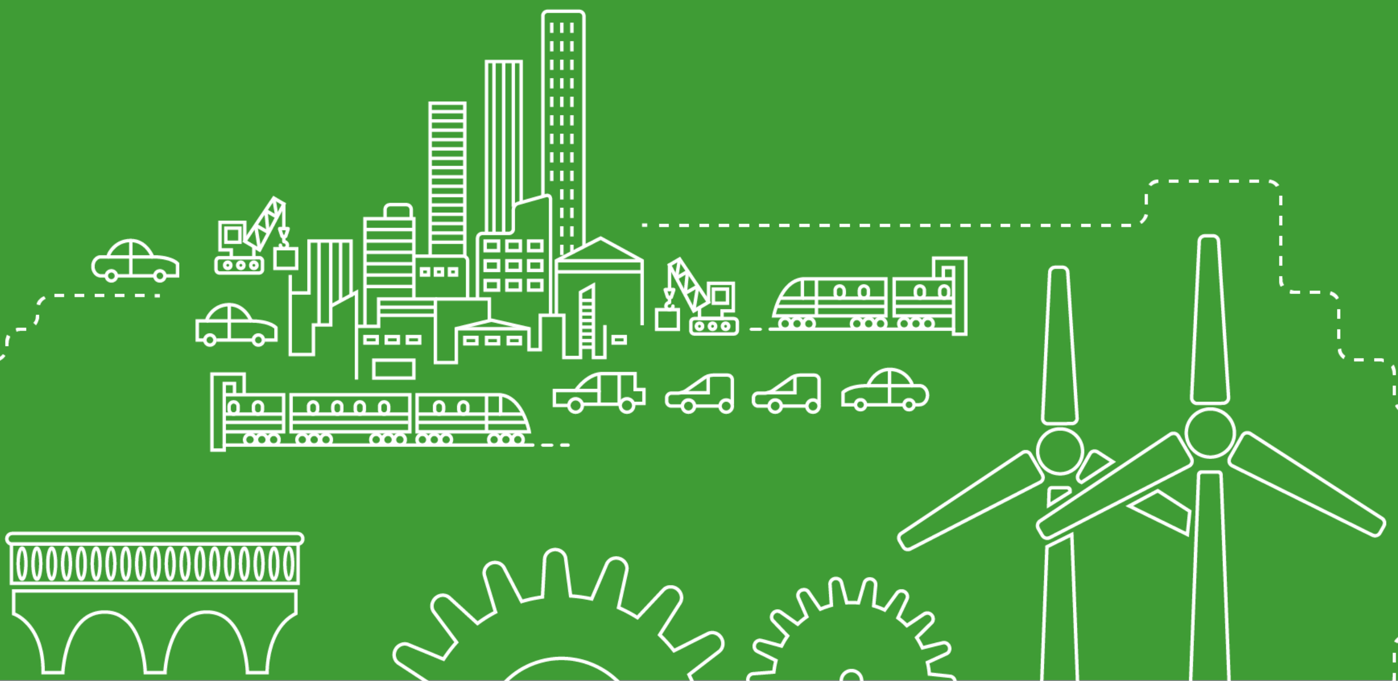
'Climate change, and society's response to it, present financial risks which are relevant to the Prudential Regulation Authority's (PRA) objectives. While the financial risks from climate change may crystallise in full over longer time horizons, they are also becoming apparent now.'

The PRA were the first regulator globally to require climate disclosures for its authorised firms when it implemented Supervisory Statement 3/19 (SS3/19). Firms were expected to develop a strategic approach to manage their risks, considering:

- governance;
- risk management;
- scenario analysis; and
- disclosure.

Since the issue of SS3/19 in April 2019, the prominence of climate related risks has greatly increased, and firms have made significant strives to comply with those requirements. Supervisory work, completed by the PRA, outlined in Dear CEO letters issued in July 2020 and October 2022, highlighted that satisfactory progress had been made but more work is required for firms to be fully compliant.

As part of our work with financial services firms, we have undertaken both advisory and assurance internal audit reviews to measure progress in implementing the strategic approach across each of the areas detailed above, in line with the requirements set out in SS3/19. This paper highlights some of the key findings and outcomes from our reviews, identifying both best practice and areas in which firms need to continue to implement climate change measures.

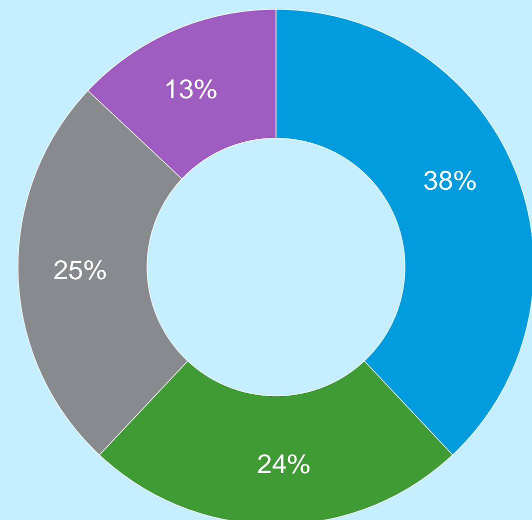


Overview of our analysis

To provide an overview of the key themes, we selected a cross-section of internal audit reviews, analysing those assignment reports to benchmark the high-level findings coming through. Our analysis allows firms to consider how their progress compares with the expectations of the PRA, and to use the identified actions and findings to aid areas of improvement within their own operations and strategic planning.

As part of our approach to categorising internal audit findings, we agree management actions with clients where there is scope for enhancing control or improving efficiency and quality, and where timely or immediate management attention is necessary. Our advisory and assurance reviews on climate change identified 134 management actions across a range of financial services institutions in our client base.

At 38%, we agreed more management actions for improvement in relation to governance. This was followed by scenario analysis and risk management, at 25% and 24% respectively. At 13%, the fewest number of management actions were agreed in relation to disclosure.



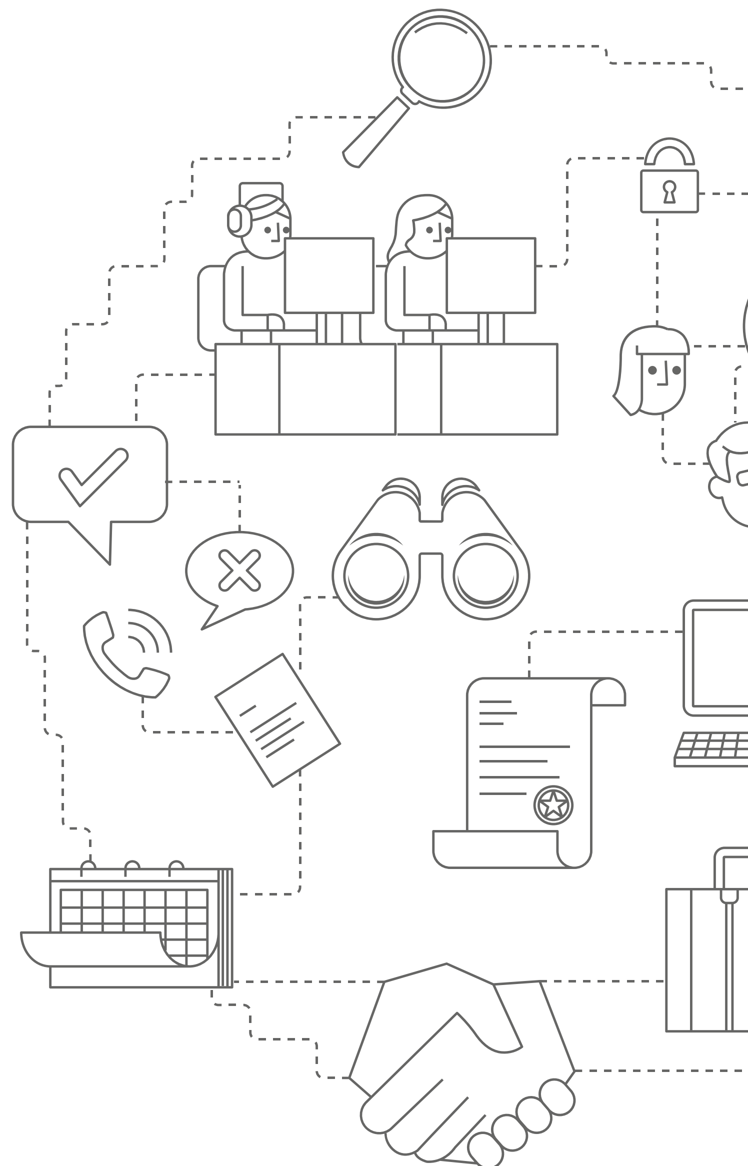
Governance
Risk management
Scenario analysis
Disclosure

Governance

‘Boards and executives should be able to demonstrate that they understand how their organisation is integrating climate considerations into their business strategies, planning, governance structures, and risk management processes. They should be able to show that the approach across these areas is coherent and supported by available metrics and risk appetites that provide an effective measure of vulnerabilities to climate risk. As part of managing the associated financial risks, firms should be able to demonstrate that, where appropriate, climate is considered in advance of business and strategic decisions.’

Areas of Good Practice

- Ownership at an individual and committee level had been documented, including assigning climate risk under the senior managers and certification regime (SM&CR). At an individual level, this was normally assigned to the Chief Executive Officer, Chief Finance Officer, or Chief Risk Officer.
- Papers were presented to oversight committees setting out each firms’ approach to managing climate change risk and adherence with requirements under SS3/19.
- Calculation of carbon emissions at a scope 1 and 2 level had been completed for a small number of firms and, where present, strategies were in place to reduce emissions.
- Two of our clients had taken green products to market.



Governance

Areas for Enhancement

- The provision of training was inconsistent and, where provided, not documented consistently. Training should provide a detailed overview of what climate change is, government policies, climate risks and what actions can be taken, providing attendees with sufficient knowledge to understand and challenge the risks of climate change. Firms should also agree an approach for training new staff or committee members.
- Firms have not formally defined a climate strategy. Whilst not a specific requirement from PRA guidance, under the Task Force on Climate Related Financial Disclosures (TCFD), a formal assessment of whether climate related risks are material, and therefore whether a firm needs to have a climate related strategy, is required.
- Whilst papers were presented, firms have not defined how the Board and responsible sub-committees are to monitor climate change through ongoing management information.
- Business plans had only limited considerations of the requirements for climate change. Plans should include key strategy indicators (KSIs) for a green strategy and community strategy that incorporates developing a strategy for how the organisation will best contribute to climate change initiatives. Firms should be committed to evolving their practices so to reduce their carbon footprint relative to size, maintain monitoring of key climate change related risks and develop effective key performance indicators (KPIs) to cover these initiatives.

Risk management

‘Firms should have embedded an appropriate understanding of climate risk within their Risk Management Framework (RMF), Risk Appetite Statement (RAS), committee structures, and three lines of defence, using both qualitative and quantitative measures. The RAS should be coherent with the RMF and tailored to each firm’s business strategy, business model, and balance sheet.

As part of their RMF work, firms should be able to demonstrate that climate risks have been appropriately factored into their quantitative analysis - for example through properly developed quantitative climate risk modelling capabilities, appropriate metrics and the use of prudent assumptions and proxies where data gaps exist.’

Areas of Good Practice

- Risk assessments, to identify climate related risks, had been completed by all firms in line with PRA requirements.
- Climate change risk(s) identified were included on firm’s risk registers following the normal risk management framework approach.
- Evidence was provided in all cases of Risk Committee’s reviewing and challenging the risks identified for climate change.

Areas for Enhancement

- Whilst risks were recorded for all firms, in several reviews, we identified only one overarching climate risk maintained in the risk register and more granular climate risks, such as specific transition risks and physical risks, are not individually assessed or considered.
- The PRA expects firms to fully understand their own climate related risks and use scenario analysis to support their perceived risks. In the majority of cases from our reviews, firms had not detailed within the registers which of the risks identified will include scenario analysis monitoring and for those that do not, how they will be monitored on an ongoing basis.
- We identified that most firms have not yet defined a risk appetite in relation to climate related risks, which should be linked to strategy. These firms have also not defined any key risk indicators (KRIs) or metrics. As a result, climate change risk may not be effectively monitored and managed.
- The management of climate related risks across the three lines of defence was not defined.
- No work had been completed by any of the firms reviewed to assess key supply chain infrastructure and how climate risks may impact this.

Scenario analysis

'Firms should be able to satisfy supervisors that they have embedded scenario analysis into their risk management and business planning processes and are able to demonstrate how the results are being used in practice, including their impact on strategic and business decision-making.

This is an evolving area, so firms should be able to explain how their current capabilities will develop over time. They should also be able to explain how the selected scenarios are relevant to their strategy and business and appropriately test their specific vulnerabilities, for example the extent to which scenarios cover extreme and less frequent events.'

Areas of Good Practice

- All firms had completed some level of scenario analysis, with two firms completing this in-house with the remainder using external third parties. Scenario analysis completed included the use of a range of potential outcomes and consider a short term and longer-term assessment of the financial risks from climate change.
- Methodologies were documented for the scenario analysis conducted, ensuring the conclusions reached could be understood.

Areas for Enhancement

- For a number of firms, it was unclear if scenario analysis would be repeated, and if so, how frequently. Without regular scenario analysis, there is a risk that climate related risks may not be effectively managed.
- The scenario analysis conducted was led by what third parties could provide rather than the specific risks each firm identified. The lack of available data makes scenario analysis challenging. However, firms must be able to demonstrate that the risks that are applicable to the organisation have been considered as opposed to trying to 'force fit' scenarios offered by external parties that may not add value.

Disclosure

'Firms have existing requirements to disclose information on material risks within their Pillar 3 disclosures (as required under Capital Requirements Regulation (575/2013) (CRR) and Solvency II), and on principal risks and uncertainties in their Strategic Report (as required under the UK Companies Act).

In addition to meeting these existing disclosure requirements, firms should consider whether further disclosures are necessary to enhance transparency on their approach to managing the financial risks from climate change.'

Areas of Good Practice

- All firms had included reference to climate change, and concluded on whether additional capital was required, in their Internal Capital Adequacy Assessment Process (ICAAP) or Own Risk and Solvency Assessment (ORSA).
- Most firms had included some reference to climate change or Environmental, Social, Governance (ESG) in their annual reports.

Areas for Enhancement

- The level of detail maintained in ICAAPs and ORSAs varied. Firms should ensure these documents record all risks identified. For those risks where scenario analysis has been applied, the actual capital at risks figures should be used. For those where scenario analysis has not been applied, the monitoring approach should be documented, and any assumed capital requirements noted. A conclusion should then be included on the level of additional capital (if any) that has been set aside to manage the climate risks identified.
- The information included in annual reports was generic and gave limited insight into how firms were managing climate risks. This was particularly relevant for the more advanced firms, as the substantial work completed was not apparent. This could result in reputational damage if it were perceived that the organisation is not taking climate change risk seriously. Firms are also potentially missing out on opportunities by not documenting the amount of work that has been completed in relation to climate change risk.
- No clients had completed a Taskforce on Climate-Related Financial Disclosure (TCFD) publication.

Key steps and considerations for firms to improve

- Now climate risk assessments have been completed and firms have a better understanding of how these risks impact their operations, climate risks should be articulated through standard risk definitions. For example, a customer in a ‘stranded’ industry being unable to service a loan would be classed as a credit risk. Monitoring of these risks can then be conducted in line with standard key risk indicators and risk appetite statements.
- As data improves and the number of third parties providing scenario analysis increases, firms should reconsider the scenario analysis conducted to ensure this is aligned to the climate risks it faces. Where quantitative analysis cannot be undertaken, qualitative assessment should still be completed to ensure all risks are effectively monitored.
- The PRA is actively encouraging firms to comply with the TCFD recommendations and the FCA’s newly introduced ESG Handbook requires its authorised asset managers, life insurers and FCA-regulated pension providers to complete TCFD publications at both an entity and product level. As such firms should look to comply with TCFD requirements to support their approach to managing climate change risk.
- The PRAs Dear CEO letter in October 2022 highlighted the importance of counterparties exposure, which had not previously been mentioned by the regulator. Firms should develop a counterparty engagement strategy to assess how counterparties are managing their own climate related risks and consider how climate risks are managed through the value chain.

Concluding comments

The firms we have worked with in the last two years on managing the financial risks from climate change have made great progress and there is now a clear understanding on what climate change is and what impact it can have. The long-term nature of climate change means it is a unique risk type that is going to require continuous monitoring by firms, not least as data improves and likely temperature increases become better understood. Further regulatory intervention is also expected that will require more work for firms to comply. As such the consideration of climate change risk is not a point in time assessment but one firms must continually revisit to ensure risks are managed effectively.

Further information

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