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RESPONSE TO PRA CONSULTATION PAPER 23/18

This is Third Generational Environmentalism's (E3G) response to the Prudential Regulation Authority's consultation paper on a draft supervisory statement on banks' and insurers' approaches to managing the financial risks from climate change, closing 15 January 2019.

Context

We consider this guidance proposal to be a crucial step in addressing systemic climate-related financial risk to the UK economy.

Information freely available to financial markets, including within the Prudential Regulation Authority (PRA)'s Insurance[1] and Banking[2] reviews, demonstrates the importance of recognising the financial risks of climate change. It is concerning that few firms are so far taking a strategic approach that considers how actions today affect future financial risks. E3G welcomes this draft supervisory statement by the PRA which confirms that climate risk is covered by existing PRA Rules, and sets expectations for different types of action by regulated firms.

The PRA makes it very clear that the draft Supervisory Statement is intended to complement and provide guidance around existing rules, which are already sufficient to encompass climate-related financial risk. This reflects the 2018 recommendations of the UK Green Finance Taskforce. We would like to see the PRA further reflect those recommendations in the future by working in close collaboration with other UK financial regulators to address climate-related financial risk and developing joint guidance.

We note that the Financial Conduct Authority (FCA) published a discussion paper on climate change and green finance[3] in October 2018, demonstrating the organisation's understanding that *'climate change is likely to have a significant impact on the UK's economy and financial services markets.'* Taken together these two consultations send an important signal to UK financial sector firms. Furthermore, E3G welcomes the FCA and PRA launch of the Climate Financial Risk Forum in early 2019 to help the financial sector manage the financial risks from climate change and support innovation for financial products and services in Green Finance.

[1] **https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/impact-of-climate-change-on-the-uk-insurance-sector.pdf**

[2] **https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/report/transition-in-thinking-the-impact-of-climate-change-on-the-uk-banking-sector.pdf?la=en&hash=A0C99529978C94AC8E1C6B4CE1EECD8C05CBF40D**

[3] DP18/8: Climate change and green finance: **https://www.fca.org.uk/publications/discussion-papers/dp18-8-climate-change-and-green-finance**

Our response has been informed by discussions and coordination between E3G, ClientEarth and other groups that have expertise on climate-related financial risk.

Overarching points

We would like to make a number of overarching points:

1. The Draft SS should refer in much greater detail to the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD). This is an internationally accepted set of recommendations which are setting the agenda for climate risk analysis. Given the utility and relevance of the TCFD recommendations to much of the PRA's supervisory expectations we would expect to see much more prominent references to the TCFD recommendations throughout the draft supervisory statement.
2. The PRA wants firms to take a sufficiently long-term view of the financial risks that can arise, beyond standard business planning horizons. (SS 3.2, page 12) but does not define what 'long' means. While it is accepted the metrics and measurements of climate risk are still in their infancy, the timelines of climate impacts are widely agreed and accepted. Reports such as the IPCC Special Report on Global Warming of 1.5 Degrees set out specific scenarios for climate impacts and emissions transitions and therefore should enable more specific guidance from the PRA on the scenario periods advised in the SS.
3. The PRA should see consistency and comparability as core objectives for this Draft SS, in line with the PRA's secondary objective to facilitate competition in the markets it regulates. It is integral to this objective that the PRA drives consistency in use of metrics and processes to assess climate risk that ensure comparability between firms and better overall risk information at the economy level.
4. We note that the draft supervisory statement does not cover what enforcement action the PRA will take in the event that its supervisory expectations are not met. The appropriate enforcement action will of course depend on which provisions of the PRA Rulebook are deemed to have been breached. We consider it would be useful to have some commentary in relation to enforcement action to help facilitate/incentivize compliance with the PRA's supervisory expectations.
5. The PRA expects firms to address the financial risks from climate change through their existing risk management frameworks (SS 3.5, page 13) but also wants firms to develop an evolving understanding of the distinctive elements of climate risk (SS 3.19, page 15). The PRA could clarify this further by signalling through the supervisory statement that existing risk management frameworks may need to be updated in the future to ensure full integration of the distinctive elements of climate risk.

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Detailed points

Risk management (page 13)

We support the assertion that the financial risks from climate change should be addressed through the existing risk management framework, and that firms should be able to evidence this in their written risk management policies, management information and board risk reports (see Paragraph 3.5 of the draft supervisory statement).

In general, Paragraphs 3.5 to 3.13 on the subject of risk management identify a number of requirements in relation to risk management and record keeping as to various procedural aspects associated with the risk management processes adopted. For example:

> 'Firms should be able to evidence [various aspects of the climate change and the risk management framework] in their written risk management policies, management information, and board risk reports.' (Paragraph 3.5).

> 'Firms should include what they determine to be any material exposures relating to the financial risks from climate change in the Internal Capital Adequacy Assessment Process (ICAAP) or Own Risk and Solvency Assessment (ORSA).' (Paragraph 3.6)

> In relation to metrics to monitor progress against overall risk strategy and risk appetite: 'Firms should set out circumstances which would trigger a review of its strategy for addressing the financial risks from climate change.' (Paragraph 3.9)

> 'The PRA expects firms to evidence how they will mitigate [the financial risks from climate change] and to have a credible plan or policies in place for managing exposures.' (Paragraph 3.10)

These requirements as to record keeping, providing evidence etc. cover a number of different types of information. Some of this information is covered by a requirement for a bilateral flow of information between a firm and the PRA (e.g. the ICAAP and the ORSA), but some of this information is covered by public reporting requirements. We suggest that Paragraphs 3.5 to 3.13 could make these distinctions clearer to provide greater assistance to firms in relation to complying with the PRA's supervisory expectations. One way of doing this would be to articulate where the requirements as to record keeping, providing evidence etc. relate to public reporting requirements and provide greater linkage to the content in Paragraphs 3.18 to 3.21 on the subject of disclosure.

In relation to Paragraphs 3.8 and 3.9 which sets out the PRA's expectation that firms should use metrics and tools to monitor progress against overall strategy and risk appetite, we consider that (for the purposes of consistency and comparability) it would be useful to articulate a set of metrics which the PRA expects to see. As set out in the preceding bullet, it would also be useful to provide greater linkage to the content in Paragraphs 3.18 to 3.21 on the subject of disclosure.

Scenario analysis (page 14)

We support the assertion in Paragraph 3.14 that 'the PRA expects firms 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.' However, we consider that more explicit direction, and setting of parameters, is required in Paragraphs 3.14 to 3.17 on the subject of scenario analysis.

Paragraph 3.15 sets out certain parameters as to the PRA's expectations of a firm's scenario analysis. We support the explicit reference to both a short term assessment and a longer term assessment. In relation to a longer term assessment, the PRA expects to see 'scenarios based around average global temperature increases consistent with, or in excess of 2°C; and scenarios where the market transition to a low-carbon economy occurs in an orderly manner, or not.' As currently drafted we consider that this paragraph permits excessive flexibility by firms - and could easily result in variable practice by firms, and scenario analyses by firms which are neither consistent nor comparable. We consider that incorporating some language to reduce this flexibility (for example, by ensuring that there is some areas of commonality for all firms) would be useful.

In addition we consider that the PRA could usefully set further expectations in relation to:

- specific time horizons for preparing disclosures;
- the quality of any third party dataset, framework, system or methodology which can be used for preparing disclosures;
- where a third-party dataset, framework, system or methodology has been used for preparing disclosures, the type of framework, system or methodology used should be disclosed (or alternatively where the firm is using its own climate scenarios then disclosing the relevant parameters of these scenarios); and
- making clear that any assumptions for calculations, estimates or projections should be disclosed.

Paragraph 3.17 states that '[t]he PRA considers the ORSA for insurers, and the ICAAP for banks, to be useful frameworks within which to consider the financial risks from climate change. Scenario analysis is a key tool that the PRA expects firms to employ as part of that assessment.' We consider that it would be useful for a link to be made here to the content in Paragraphs 3.18 to 3.21 on the subject of disclosure - so that firms provide a consistent set of scenarios to each reporting channel whether that be a bilateral flow of information between the firm and the PRA [as in the case of the ORSA and the ICAAP], or a public disclosure requirement.

Disclosure (page 15)

Paragraph 3.18 states that '[b]anks and insurers have existing requirements to disclose information on material risks within their Pillar 3 disclosures [...] and on principal risks and uncertainties in their Strategic Report.' We consider that this could be improved to also refer

to the impact of climate change on financial statements. As set out in the TCFD Final Report, the recommended disclosures should result in more quantitative financial disclosures about the financial impact that climate-related risks have or could have on an organization.

Specifically, asset impairments may result from assets adversely impacted by the effects of climate change and/or additional liabilities may need to be recorded to account for regulatory fines and penalties resulting from enhanced regulatory standards. Additionally, cash flows from operations, net income, and access to capital could all be impacted by the effects of climate-related risks (and opportunities).

Finally, careful consideration should be given to the linkage between scenario analyses performed to assess the resilience of an organization's strategy to climate-related risks and opportunities and assumptions underlying cash flow analyses used to assess asset (e.g., goodwill, intangibles, and fixed assets) impairments.[4]

Paragraph 3.19 states that '[t]he PRA expects firms to consider the extent to which the disclosure requirements […] reflect their engagement with the expectations in this [supervisory statement] and whether additional disclosures are necessary to enhance the transparency of the firm's approach to the financial risks from climate change.' We consider that it would be useful to refer to legal requirements here - framing these disclosures through the lens of the expectations in the supervisory statement masks the reality that these are existing legal requirements.

Paragraph 3.20 states that '[a]ll firms within the scope of this [supervisory statement] should consider the relevance of disclosing how climate-related financial risks are integrated into governance and management processes, including the process by which a firm has assessed whether these risks are considered material or principal risks.' We reiterate the point above that the framing of these disclosures again masks the reality that these are existing legal requirements.

Paragraph 3.21 states that '[t]he PRA expects firms to engage with wider initiatives on climate-related financial disclosures which are comparable across firms, for example the 'Recommendations of the Taskforce on Climate-related Financial Disclosure' published in June 2017.' In light of the implicit reliance on the TCFD recommendations in other parts of the draft supervisory statement, this 'light touch' reference to the TCFD recommendations is somewhat incongruous.

Paragraph 3.21 further states that '[v]arious other groups have done work on this area to help provide tools or case studies for organisations to consider when making climate related financial disclosures. The PRA expects firms to consider whether they would benefit from engaging with some of these initiatives or making use of some of these tools.' We consider that it would be useful to articulate some of these tools. This also relates to the points made

[4] TCFD, 2017. Final Report Recommendations of the Task Force on Climate-related Financial Disclosures. p.37.

above that setting of further parameters is required in Paragraphs 3.14 to 3.17 on the subject of scenario analysis.

In this regard we draw your attention to the Green Finance Taskforce (GFT) Report which set out more detailed observations about how to implement the TCFD recommendations in the UK[5]. In particular, the GFT Report recommends that Government and financial regulators should create and publish guidelines by Summer 2019 which clarify certain TCFD recommendations to make them more readily implementable (for example in relation to physical climate scenario analysis and the disclosure of assumptions).

The guidelines should:

> define which preparers are covered by disclosure requirements;

> ensure that information is disclosed on a consistent and transparent basis. The guidelines should make clear that assumptions used for calculations, estimates or projections should also be disclosed by preparers;

> ensure that preparers provide scenario-based disclosures of how their business strategies and financial planning may be affected by climate-related risks and opportunities and the associated time horizons considered;

> ensure that preparers are aware of the requirement and are supported in the reporting of revenues from green business areas; and

> take account of how different jurisdictions are responding to new disclosure needs.

The GFT Report also recommends that the GFI should be formally tasked by the Government and financial regulators to implement an inclusive process involving key private sector stakeholders to help generate the guidelines. This could significantly reduce the burden on the Government and financial regulators associated with preparing new guidance in a short period of time.

The Green Finance Initiative (GFI) has already made a start on the recommendation in the GFT Report in relation to convening sector-specific preparer forums to support guideline adoption and implementation. On 19 November 2018, the GFI, in partnership with Principles for Responsible Investment (PRI) and CDP hosted the UK's first TCFD Preparers Forum. This brought businesses and the financial sector together to learn how both preparers are implementing the TCFD framework and how data users are integrating this information into their financial products, services and investments.

Supervisory and regulatory cooperation

Other UK financial regulators are taking steps to increase oversight of climate-related financial risk within their own regulatory remit (e.g. Financial Conduct Authority (FCA) Discussion Paper DP18/8 Climate Change and Green Finance).

[5] Pages 37-39, Green Finance Taskforce, ‘Accelerating Green Finance’, **http://greenfinanceinitiative.org/workstreams/green-finance-taskforce/**

The FCA and PRA have been working closely together to develop a joined-up approach to enhance the resilience of the UK financial system to climate change and will be establishing a Climate Financial Risk Forum.

In addition, we believe that many of the PRA's expectations in the draft supervisory statement will require coordination with other financial regulators in order to provide effective oversight. This is most clearly evident in relation to the PRA's expectations in relation to disclosure. For example Paragraph 3.18 articulates the requirement to disclose principal risks and uncertainties in the strategic report. As the Financial Reporting Council is the regulator responsible for providing oversight of strategic report disclosures for compliance with legal requirements, we consider that in order for the PRA to satisfy itself as to its supervisory expectations, a degree of coordination will be required with the FRC.

Another example, is the expectations set out in Paragraph 3.4 that 'the board and the highest level of executive management should identify and allocate responsibility for identifying and managing financial risks from climate change to the relevant existing Senior Management Function(s) (SMF(s)) most appropriate within the firm's organisational structure and risk profile, and ensure that these responsibilities are included in the SMF(s)'s Statement of Responsibilities.' We are aware that the FCA is also involved in providing oversight of the SM&CR - and indeed this regime is currently being extended to cover FCA solo regulated firms. We suggest therefore that this is another area, where in order for the PRA to satisfy itself as to its supervisory expectations, a degree of coordination will be required with the FCA.

In light of the developments by other financial regulators, and the extent of the PRA's expectations in the draft supervisory statement, we think that it would be useful to publicly articulate how the PRA will work with other UK financial regulators to provide effective oversight and enforcement in relation to climate related financial risk. This could take the form of a MoU which is signed by all financial regulators on this issue (along similar lines to the existing MoUs which exist between financial regulators).

Engagement with clients, counterparties and investees

SS 3.21 (page 15) suggests that "firms would benefit from greater disclosure in the wider economy, and they would be in a strong position to encourage it through their ownership of financial assets." We assume that it relates to SS 3.12, "…firms should seek to understand the potential current and future impacts of the physical and transition risk factors on their clients, counterparties, and organisations in which the firm invests or may invest. To the extent that firms do not have the necessary information, firms are expected to engage with clients and counterparties where this information is considered material to a firm's own risks". It would be helpful to clarify whether the text on SS 3.21 is a restatement of the actions suggested in SS 3.12, or whether additional actions are being suggested such as membership of partnerships or coalitions which conduct joint or co-ordinated engagement.

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Concluding comments

E3G is highly supportive of the PRA's work and its goals for this draft supervisory statement, and we thank the PRA for the opportunity to comment. We will be happy to make ourselves available to discuss any of the content in this submission.

Signed

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About Third Generation Environmentalism (E3G)

Third Generation Environmentalism Ltd. (E3G) is a UK-based not-for-profit think tank working to accelerate the global transition to a low carbon economy. In 2017 E3G delivered "15 Steps to Green Finance" with the City of London Corporation. This led to E3G's invitation to act as the Secretariat for the UK's Green Finance Taskforce (GFT) which made recommendations in March 2018 on how the government and the private sector can work together to make green finance an integral part of UK financial services.