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PRA prompts financial firms to focus on climate risks

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The PRA is stepping up pressure on banks to pay more attention to climate change related financial risks following a consultation that is likely to be a step towards eventual regulation. By Justin Pugsley

Depending on the point of view, the UK's Prudential Regulatory Authority's (PRA) demand that banks and insurers make climate change risks part of their long-term planning is either a big step forward or simply does not go far enough.

For the green lobby in particular, the PRA should have made climate change financial reporting and planning mandatory.

They see bank lending policies as potentially supporting high carbon emitting industries and want banks to play a greater role in pricing climate risk into finance and to help these industries to quickly transition towards low carbon business models.

But that was a step too far for regulators and the industry at this stage.

"It might be a bit premature to make climate impact assessments mandatory, because the TCFD [the task force on climate related financial disclosures] report was only published in June 2017," says Michael Hutchinson, a partner at Mayer Brown. In effect, firms have not yet had enough time to develop standardised methodologies for creating scenario analysis and measuring climate-related risks.

Nonetheless, many do see it as a bold move and one which is likely to have a considerable impact on the behaviour of financial firms.

Indeed, the PRA and the UK Financial Conduct Authority are also establishing a Climate Financial Risk Forum involving senior industry staff and technical experts. It will look to enhance ways of managing financial risks related to climate change and support innovation in green finance. This includes supporting the development of analytical and technical tools for climate-related scenarios.

The consultative document called '*Enhancing banks' and insurers' approaches to managing the financial risks from climate change*', builds on engagement with financial firms and a number of recent studies carried out by UK regulators. The consultation closes on January 15, 2019 and will be followed by more detailed guidance from late 2019 onwards.

Creating urgency

Clearly the PRA's consultation and recommendations are designed to drive a sense of urgency among financial firms over climate change, particularly the banks. In terms of awareness, they have tended to lag insurers, which are often financially exposed to destructive weather events, and also asset managers, many of whom have become very proactive in driving change within listed companies.

The regulator described climate risks as "far reaching on both breadth and magnitude" and said that their impact was potentially larger than other types of risks. This implies that they could have systemic consequences for the financial system if weather systems become too unstable and volatile as seems to be currently happening.

In a survey published on September 26, covering 90% of the UK banking sector representing more than £11tn ($14.1tn) in asset, the regulator found that although 70% of banks recognise that climate change poses financial risks, only 10% manage these risks comprehensively and take a long-term strategic view of them. but 30% of banks still see climate change as just a corporate social responsibility issue.

The PRA wants financial firms to account for the immediate physical risks from climate change and from transitioning to a low carbon economy. This might include more underwriting and reserving for credit and market risk.

The regulator noted that weather hazards have tripled since the 1980s, leading to related inflation-adjusted insurance losses to rise from an annual average of around $10bn to about $55bn over the last decade. The PRA is concerned that severe weather events, that say damage property due to flooding or disrupt supply chains, could lead to higher loan default rates.

It is looking to establish an effective governance, risk management, scenario analysis and disclosure regime for climate change financial risks.

Ideally, the PRA would like to see firms embedding financial risks from climate change into their governance arrangements, incorporate the financial risks from climate change into existing risk management practice, use long-term scenario analysis to inform their strategy and risk assessment and identification and to develop an approach to disclosure on the financial risks from climate change.

Going to the board

Probably the most significant proposal is for financial firms to have a board level member and a sub-committee to be responsible for managing financial risks from climate change with input into business strategy and risk appetite. This would include making it part of the senior managers' function.

“It is a significant development that somebody at board level should be made specifically responsible for assessing climate impact across the business,” says Mr Hutchinson, adding that this could drive considerable change in management thinking around climate change.

“The PRA has increasingly been putting pressure on banks and insurers to make individuals accountable for the work they do, and the risks they face. This can be seen clearly in the Senior Managers and Certification Regime, and also in the regulator’s approach to operational resilience and now climate change. Risk is no longer managed in the boiler room, but the board room,” says Jon Holt, head of financial services at KPMG UK.

He warns that if banks and insurers do not make sufficient progress in their governance and strategic thinking on climate change they can expect to see these considerations reflected in higher capital requirements.

The PRA also proposes that firms address the financial risks from climate change through their existing risk management framework, which echoes the approach taken by the the TCFD, which seeks to use the existing financial reporting infrastructure.

The PRA’s consultation might be short in length, reflecting a current lack of financial insights around climate change, but it is very likely to be a step down a path towards a more mandated approach to climate change related issues.