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Newsflash

Letter from Sam Woods - Thematic feedback on the PRA's supervision of climate-related financial risk

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Following the PRA's publication of Supervisory Statement (SS) 3/19, detailing their expectations for firms' management of climate-related financial risks, the PRA began actively supervising firms against those expectations in 2022. On 21 October 2022, Sam Woods published a letter: Thematic feedback on the PRA's supervision of climate-related financial risk and the Bank of England's Climate Biennial Exploratory Scenario exercise, setting out how the PRA expect firms to be able to showcase their approaches to managing climate risks by now.

Capabilities that the PRA expect firms to be able to demonstrate by now

All UK insurers and reinsurers should now be able to demonstrate:

1. How they are responding to PRA expectations
2. Steps being taken to address any barriers to progress
3. Measures that have been put in place to allow them to enhance their approaches as industry practice develops and new data and tools emerge.

The PRA recognises that banks and insurers have taken "concrete and positive steps" to implement their expectations, progressing their ability to address the opportunities and risks presented by climate change. However, it is recognised that all firms need to make further progress across the areas reviewed.

For each core area identified in SS3/19: governance, risk management, scenario analysis, data and disclosure we have outlined the PRA's expectations, analysis of firms' progression thus far, and areas identified for improvement.

Governance

What's expected?

- Understanding of the integration of climate considerations into business strategies, planning, governance structures and risk management processes.
- A coherent approach should be taken across the above areas, supported by available metrics and risk appetites.
- Climate considered in advance of business and strategic decisions.

The PRA concluded that firms have made significant progress thus far in meeting PRA expectations for governance of climate risks.

Data

What's expected?

- Ability to explain the method of identifying significant data gaps, approach to close those gaps, and processes in place to ensure incorporation of data developments and tools in approach.
- Have contingency solutions in place.

Although effectively used by some firms, all firms needed more robust, standardised climate-related data of a sufficient volume. Most firms were either reliant on third parties for data and models or unable to obtain the relevant data. Data gaps were a common theme amongst the obstacles to determining views on climate-related risks.

Disclosure

Most firms have developed an approach to disclose information on climate risks, risk management and scenario analysis. However, all firms need to continue development of their disclosures as their understanding of climate risks relevant to their business matures.

Firms should look to develop a consistent and integrated approach across all forms of annual reporting, including financial reports, standalone climate disclosures, and Pillar 3 or SFCR disclosures.

Risk Management

Firms had generally made progress on risk management, although the PRA notes that most firms' work on climate risk management and mitigation (including capital allocation) was still in development.

	What's expected?	Areas for improvement
Frameworks and tolerances	• Good understanding of climate risk embedded in Risk Management Framework (RMF), Risk Appetite Statement (RAS), committee structures, and the three lines of defence, using both qualitative and quantitative measures. • RAS tailored to the firm's business strategy, business model, and balance sheet.	• Ensure the RMF includes quantitative risk appetite metrics. • Quantitative elements should be included in the RAS. • Further consideration and embedding of climate risk management needed for underwriting practices.
Modelling	• Climate risks factored into quantitative analysis. • Able to explain action taken to identify areas of development and relevant data gaps. • Use of prudent assumptions and proxies for data challenges.	• Develop quantitative climate risk modelling capabilities and use of prudent assumptions and proxies where there are data challenges. • Further work to address data gaps identified.
Counterparties' exposures	• An engagement strategy established to provide information on counterparties' management of climate risks.	• Further consideration of exiting particular customers or sectors, including impact on wider market dynamics.

Capital	• Firms' Own Risk and Solvency Assessments (ORSAs) or Internal Capital Adequacy Assessment Processes (ICAAPs) should provide a clear analysis of climate risks and capital.
	• Stress testing calculations and methodologies allow satisfactory assessment of the underlying assumptions and whether the outputs are appropriately factored into firms' capital strategies and decisions.
		• Methodically consider how climate risks could impact capital, allowing for better understanding and ability to explain reasons for holding, or not holding, specific capital for those risks.
		• Capture climate in macroeconomic scenarios.
		• Use specific climate scenarios to evidence analysis of risk.
		• Provide sufficient information in ORSAs or ICAAPs to enable a reader to fully understand firms' analysis, including:
		  ○ Modelling approaches
		  ○ Model types and proxies
		  ○ Assumptions and judgements including uncertainties.

Scenario Analysis

The PRA concluded that scenario analysis capabilities were not sufficiently well developed to support effective decision-making, with the main barriers being generation, collation, cleaning, analysis, and integration of data to carry out scenario analysis, with strong links to business strategy.

Firms using climate risk models tended to be in early stages of development and some made use of a combination of new models, existing models, and third-party solutions to estimate impacts. Of these, all used proxies, manual adjustments, and simplifying assumptions. However, there was limited information on how data gaps and methodological challenges were addressed.

What's expected?	Areas for improvement			
	Contextual Information	**Consistency**	**Scenario Design**	**Other**
• Scenario analysis to be embedded into risk management and business planning processes • Ability to show how results of scenario analysis are being used in practice. • Ability to explain how current capabilities will develop over time. • Ability to explain how selected scenarios are relevant to business strategy and appropriately test their specific vulnerabilities.	Articulate the objectives for which your scenario analysis has been designed, or the ways in which your approach has been calibrated to meet those objectives.	Clearly show whether outputs from scenario analysis have been integrated into ICAAP and ORSA processes, using appropriately prudent calibrations and assumptions where required.	• Indicate whether steps have been taken to ensure data and assumptions are consistent with the relevant scenario. • Run scenarios that are relevant to the firm's business. • Appropriately test firm specific vulnerabilities. • Consider both probabilistic events (e.g., changes in weather patterns) and tail events (e.g., extreme weather events). • Embed physical risk into corporate modelling. • Include more detailed analysis of asset loss by counterparties and how their supply chains and markets in which they operate are impacted by physical risk.	• Consider the uncertainty in your climate risks analysis and take this into account when using the results, e.g., via use of prudent assumptions, manual adjustments, or sensitivity analysis. • Ability to model a wide range of physical vulnerabilities in assessment of underwriting risk.

Climate and Regulatory Capital

In October 2021, the Bank of England published its Climate Change Adaptation Report, which examined the relationship between climate change and the banking and insurance regulatory capital regimes, including plans for future work. Additionally, the BoE is engaging in conversations with the Basel Committee on Banking Supervision and international insurance standard-setting bodies to gain an understanding of how climate risks interact.

In October 2022, the BoE facilitated a Climate and Capital conference to discuss issues associated with adjusting the UK's capital framework to account for climate-related financial risks. Sam Woods delivered the opening speech, stating that the BoE's have a "completely open mind" regarding the incorporation of climate-related risks in capital frameworks. Woods said there is uncertainty about how to capture climate-related risks but challenged whether it's sufficiently different from uncertainty in other areas of risk to require a brand-new approach. He also noted the BoE's desire to contribute to international standards and spark debate elsewhere.

Within Woods' letter it is noted that some firms are holding capital for climate risks. However, within Hymans Robertson's last Climate Change survey, none of the 23 firms surveyed were currently holding capital against this risk under their pillar 1 or pillar 2 requirements. We will be carrying out our annual refresh of this survey soon, with results expected in early 2023.

Next Steps

Going forwards, compliance with expectations set out in SS3/19 will be assessed on an ongoing basis and firms should continue to develop their climate risk management through regular supervisory engagements and reviews. Firms' Board and senior management teams should demonstrate oversight and control of their approach to climate risk management. Firms that fail to meet the PRA's expectations will be asked to provide a roadmap of how they intend to overcome the barriers to progress. Supervisors will determine whether additional steps are required to ensure climate risks are adequately addressed and, if necessary, may take further action.

At Hymans Robertson, we have been working with insurers on their scenario modelling, development of data provision, compliance with TCFD and other climate-related regulatory requirements, and setting net-zero transition strategies. If you are interested in any of these topics, or you would like to discuss climate change or any of the above further, please get in touch.

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