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Climate change and banks

Questions Boards should be asking

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Climate change is a key concern across all sectors of the economy. Financial services regulators worldwide are moving to ensure banks identify risk exposures from climate change, and establish strategies and adjust business models to manage them. Regulators expect Boards, in particular non-executive directors (NEDs), to pose robust challenge and provide effective oversight of their bank's identification and management of climate risk. Although the broad topics are familiar, the specific issues pertinent to climate change are new, significant and complex. The questions explored below help Boards navigate this difficult environment and meet regulators' expectations.

Responding to a climate emergency

There has been a marked shift in how people view climate change. The public demands that action is taken now. Climate change is at the top of government agendas, with governments focused on how they can meet key commitments, such as reaching net zero carbon emissions by 2050. Meeting these commitments will require a transition to a fundamentally different and more sustainable economy. In support of this, there has been an abundance of legislative and supervisory measures for financial services firms on climate change.

Bank supervisors have focused their attention on how the physical, transition and liability risks from climate change[1] translate into financial and non-financial risks, and how banks should manage them. In 2021, banks face a number of key regulatory and supervisory deadlines[2]. For example, the UK Prudential Regulation Authority (PRA) has set an end-2021 deadline for UK banks (and insurers) to have embedded fully their approaches to managing climate-related financial risks, and the Bank of England will launch its climate change-focused Biennial Exploratory Scenario in June 2021. The European Central Bank (ECB) will also require banks in the Banking Union to perform a self-assessment of their compliance with its guide on climate-related and environmental risks in 2021, before it conducts a full supervisory review in 2022.

While Europe has so far led the way on the regulatory response to climate risk, there have also been some key developments in the US. In September, the Commodity Futures Trading Commission published for the first time a report on managing climate risks. Following this report, the New York State Department of Financial Services became the first US regulator to set out climate-related expectations for firms under its supervision[3]. We expect this regulatory focus on climate change to continue apace with the incoming Biden Administration.

But for banks, this is not just about meeting supervisory deadlines. Addressing climate change is not a "nice to have" – it is non-negotiable. Boards that do not act now run the risk of not having a viable business in the medium to long term. They may also fail to take advantage of the opportunities which arise in the transition to a greener economy.

Getting ahead on the future of financial services can create a considerable competitive advantage. For example, this year has seen significant inflows to green investment products, strong performance by green equity indices, and a rapid growth in the market for green bonds, where deals are often oversubscribed and there is evidence of advantageous pricing in primary markets (a "greenium") for green bonds compared to conventional bonds[4].

In addressing climate change, Boards must establish a strategy and risk appetite which accommodate and reconcile both the risks and opportunities arising from climate change and the transition to a greener economy. Moreover, Boards must ensure that the strategy and risk appetite are reflected in, and supported by, the bank's risk management and governance structures.

We set out below some high-level considerations on the key areas which bank Boards should consider as they go about these tasks.

Climate change poses new, significant and complex challenges

Regulators worldwide have published a number of documents, setting out their expectations on climate risk management[5]. The frameworks within which these expectations are developed are very similar to those that would apply for other risk types, meaning that banks should be able to leverage, to some extent, existing governance and risk management architecture. However, there are a number of challenges which set climate risk apart, and mean that banks cannot just "copy and paste" what they do for other risk types (Figure 1).

Figure 1. The challenges: Why you cannot just "copy and paste" what you do for other risk types

Overcoming the challenges: the key themes Boards should consider

Boards should prioritise five themes in order to provide robust challenge and effective oversight of their bank's approach to the identification and management of climate risk. The Board should focus on these themes to satisfy itself that the bank is managing its risks effectively and tackling regulatory expectations. In doing so, the Board should bear in mind the challenges identified above (Figure 1) and probe the extent to which the bank is focused on, and addressing these challenges.

1 Strategy and business model

To ensure long-term resilience, the bank must address climate risks within its strategy and business model. This ensures a coherent approach across the corporate ambition of the bank with respect to climate change and its business activities, and helps to drive a consistent approach to managing risks across all aspects of the bank's operations. Failure to tackle climate risks in this way could also expose the bank to significant reputational damage, if stakeholders perceive that the stated ambitions of the bank are not reflected in its actions. When considering its ambitions, the Board should also consider whether it wants the bank to be a "first mover", for example, in terms of its market disclosures, or the development of new products and services.

Strategy and business model

The bank should embed climate change considerations into its strategy and business model, incorporating a clear path towards meeting global targets e.g. net zero emissions. The bank must ensure it converts words into action.

Considerations for the Board

- The **resilience of the business model** to climate change is considered in the short, medium and long term.
- Tools (e.g. scenario analysis) are used to ensure the strategy takes into account the external **business environment.**
- Specific **strategic objectives**, limits and key performance indicators are set in relation to climate change.
- The **opportunities** for products and services in the transition to a greener economy are considered.
- The **engagement policy** addresses communication to stakeholders and support for clients in meeting their climate objectives.

Example question

Is our strategy for managing physical, transition and liability risks aligned with our corporate goals on sustainability?

2 Governance and culture

Governance structures and the bank's culture must support risk management and be effective in cascading the climate change strategy and risk appetite throughout the firm. The bank should have a clear escalation and decision-making framework for climate risks, including tangible evidence that risks are assessed, monitored, managed and reported at all appropriate levels; and that climate change-related information is influencing decisions. Banks must develop a roadmap for addressing the identified risks and opportunities. Governance structures and risk management must be adequately resourced. The Board must show leadership in setting the agenda on climate change and the "tone from the top".

Governance and culture

The Board is responsible for setting the "tone from the top" and establishing the strategy, risk culture, risk appetite and internal control framework on climate risk, ensuring allocation of responsibilities across the three lines of defence.

Considerations for the Board

- The Board **drives the agenda** on climate change within the bank.
- The Board challenges senior managers on gaps and uncertainties in climate change data and **MI.**
- **Training and experience gaps** on climate change are identified and resourced, and the role of external experts is considered.
- **Governance structures** are effective in cascading the climate change strategy and risk appetite across the bank.
- The bank's **culture, remuneration and incentives** are aligned to the climate change strategy.

Example question

Do we have access to sufficient breadth of knowledge, skills and experience to challenge senior management effectively?

3 Risk management

Climate risk must be fully integrated into the bank's risk management framework, from setting risk appetite, through risk identification, to risk mitigation. This will take time to achieve, in particular as data availability and risk-modelling techniques evolve, but supervisors expect to see the bank investing sufficient effort now and with a plan for investment to develop their capabilities further. A clear risk appetite statement aligned with the business strategy and the bank's overall climate change strategy is critical. The bank must ensure that it has identified all exposures, and is using relevant climate risk metrics mapped onto its portfolios. A key task for the Board is to ensure that it is aware of uncertainties in climate risk data, and is confident that the bank has a well documented plan for managing those areas of uncertainty.

Risk management

The Board is responsible for setting the bank's risk appetite, but first must be confident in the bank's risk identification and the risk metrics being used. In the decisions it takes, the Board needs to understand the uncertainties in the bank's climate risk data.

Considerations for the Board

- The **risk identification** process covers the full range of climate risks to which the bank is exposed.
- Climate **risk metrics** are mapped appropriately onto the bank's portfolios.
- The Board understands the **scale of uncertainties** in climate risk exposure measures.
- A climate **risk appetite** is set at Board level, which is aligned with the bank's climate change strategy.
- Where material climate risks are discovered, **action** is taken to mitigate those risks.

Example question

Are we comfortable that we understand the scale of uncertainties in climate risk exposure measures?

4 Scenario analysis

Scenario analysis is an important tool for understanding the scale of exposures to climate risk, and for strategic planning. The bank should consider a sufficiently broad range of scenarios and with sufficient granularity to enable it to assess adequately the risks to meeting its risk management objectives and wider climate change targets. The Board should be confident that the bank has the required capabilities and infrastructure to undertake rigorous scenario analysis, and that the scenarios being used are sufficiently severe and comprehensive. The Board should challenge senior managers on whether they are confident that, under each of the scenarios used, the bank will have adequate access to financial resources.

Scenario analysis

The bank must develop a fully integrated approach to scenario analysis. The Board must ensure that the bank's scenario analysis supports its strategy and its ability to meet climate-related targets.

Considerations for the Board

- **Scenario analysis is aligned** with risk management objectives and wider climate strategy.
- There are appropriate **capabilities and infrastructure** within the bank to conduct robust scenario analysis.
- A range of potential scenarios are considered, and **selected scenarios** are sufficiently severe and comprehensive.
- The bank is well prepared for meeting **regulatory expectations** (e.g. ICAAP and stress testing).
- The **management actions** and associated costs in each scenario are understood.

Example question

Based on our scenario analysis, are we confident that the risk to future access to financial resources sits within our risk appetite?

5 Liability risk

Climate change raises a number of liability risks for banks, with market data and "greenwashing" of particular concern for supervisors. To mitigate the liability risk which may arise due to failures in disclosure, it is key that banks provide the market with sufficient reliable information about their material exposures to climate change in line with regulatory requirements, and consider their alignment to the Task Force on Climate-related Financial Disclosures (TCFD) guidelines. In terms of products and services, action to channel funding to sustainable investments provides banks with opportunities, e.g. in relation to green bonds, loans, mortgages, and securitisation products. However, the implications of climate change for conduct risk are still relatively unexplored[6].

To guard against "greenwashing" and other related conduct risks, the bank must ensure that for the products it offers or deals in, it has implemented a robust controls framework – across valuation, modelling, accounting, due diligence, product governance, suitability and disclosure. The Board should also take a view on the risk to the bank of future regulatory action on (mis)conduct. In doing so, it should be alert to risks which arise from data, whether in terms of its availability and/or quality. In particular, the current absence of globally consistent product standards, taxonomies and standards on assurance means that current assessments of green products are necessarily subjective.

Liability risk

The Board should ensure that liability risks in relation to market disclosures and conduct are managed effectively. On conduct, the focus should be on "greenwashing", product suitability, client disclosures, product governance, investment decision-making, and models and pricing.

Considerations for the Board

- Standards on **market disclosure** on climate change are met and data gaps are understood.
- **Product offering** is aligned to the climate change strategy and reflected in internal control processes.
- Material **conduct risks are identified** and managed in line with wider operational risks.
- There is a robust framework for **green products**, with effective controls.
- **MI** tests whether green products deliver fair customer outcomes.

Example question

What gives us confidence that the bank has identified its material liability risks in relation to climate change?

Positioning for the future

The response to climate risk will touch all aspects of a bank's business strategy and operations. Banks themselves have the opportunity to deploy their balance sheet and business activities to finance and drive the transition to a greener economy. They will also need to respond to customer demand in relation to green products and service evolving client needs.

The Board has a vital role to play in this transition. Given the intensifying scrutiny from regulators and all stakeholders, effective engagement with this topic now will enable the Board to help drive long-term sustainable differentiation in the marketplace for the bank, meet stakeholder expectations, and manage climate risks effectively.

Contacts

Please contact us if you would like a more detailed conversation on the challenges and themes discussed in this paper and the questions which you, as a Board member, should be asking.

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1. The primary transmission channels for climate risk can be described as physical risk (the risk posed, either directly to a firm or by a firm's exposure to counterparties, by the physical effects of climate change), transition risk (the risk posed, either directly to a firm or by a firm's exposure to counterparties, by the transition to a sustainable economy, through changes in policy, technology, or consumer preferences), and liability risk (the risks posed by the firm, or a counterparty, potentially being held accountable for the negative impact of their activities on the environment).
2. Examples include the Financial Conduct Authority (FCA) announcement that from reporting periods beginning 1 January 2021, prominent listed companies will be required to make disclosures consistent with the TCFD recommendations on a "comply or explain" basis, with the requirements being applied to a wider range of companies by 2025; the EU Disclosure Regulation (due to apply from March 2021); the incorporation of environmental, social and governance (ESG) preferences into the MiFID II suitability process (expected to apply from Q1/2 2022); and the EU Taxonomy Regulation (due to be phased in from January 2022). The ECB will also run a climate-related stress test in 2022.
3. Commodity Futures Trading Commission, Managing Climate Risk in the US Financial System, September 2020; New York State Department of Financial Services, Letter to Chief Executive Officers of New York State Regulated Financial Institutions, October 2020.
4. Andrew Hauser, Bank of England speech on climate change, October 2020.
5. Examples include the PRA Dear CEO letter on managing climate-related financial risk, July 2020; the ECB Guide on climate-related and environmental risks, November 2020; the Network for Greening the Financial System (NGFS) Guide for supervisors, May 2020; and the European Banking Authority (EBA) Discussion Paper on management and supervision of ESG risks for credit institutions and investment firms, October 2020.
6. The FCA set out its approach to climate change and green finance in its Feedback to DP 18/18, October 2019.

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