HYMANS ROBERTSON

Newsflash

Climate change: recent regulatory developments

On 15 April 2019 the PRA published further guidance and clarity on its expectations with respect to the financial risks insurers face due to climate change. This came in the form of a Policy Statement (PS11/19) and draft climate change scenarios, set to form part of the Life Insurance Stress Test 2019.

In this newsflash, we look at some of the key takeaways from these publications, which include:

- A new, expansive set of requirements – **effective immediately** – to encourage the identification, management and reporting of the financial risks associated with climate change.
- A request for larger insurers to perform climate-related stresses to their balance sheets by **30 September 2019.**
- A requirement for all firms to assign responsibility for identifying and managing climate risks to a relevant Senior Management Function (SMF) holder by **15 October 2019**.

How have we arrived here?

In October 2018 the PRA issued a consultation paper (CP23/18) which included a draft Supervisory Statement on "*Enhancing banks' and insurers' approaches to managing the financial risks from climate change*".

This paper firstly laid out the PRA's view on the nature of the financial risks insurers are likely to face from climate change, namely:

- **Physical risks** – incurred due to specific weather events (e.g. floods, heatwaves) and longer term shifts in the climate (e.g. rising temperatures and sea levels).
- **Transition risks** – arising from the shift to a low-carbon economy, including tightening of regulation and the emergence of disruptive technology.

It highlights the far-reaching nature of these risks as well as their uncertain time horizons, but emphasises the need to act in the short-term to avoid a "too little, too late" scenario.

The paper also outlined PRA's expectations on this topic across four broad areas: governance, risk management, scenario analysis and disclosure.

How have companies reacted?

In a word, positively. The general consensus from the responses to the consultation paper was that more needs to be done and this represents a step forward in addressing the looming challenges of climate change. Some respondents even pushed for more stringent requirements.

Despite overarching positivity firms did raise some concerns, for example, in the following areas:

- **Lack of technical expertise** – particularly in relation to:
    - the identification of where climate risk arises on the balance sheet;
    - the development of appropriate stress scenarios; and
    - the assignment of responsibility to a SMF holder.

- **Resourcing** – the additional time and effort that will be required to carry out scenario analysis and to develop new disclosures.

- **Lack of guidance** – further regulatory guidance was sought on issues ranging from the application of governance requirements and the level of expertise expected, to the appropriate metrics to use and how to deal with data gaps.

What are the PRA's expectations?

Following the consultation, the PRA has now issued its expectations in a finalised Supervisory Statement (SS3/19) accompanying PS11/19. The can be summarised as follows:

Scenario analysis

Scenario analysis should be used to explore the resilience and vulnerabilities of a firm's business model to a range of climate change outcomes.

Required actions	▪ Firms should use scenario analysis to understand the impact of the financial risks from climate change on their solvency, liquidity and ability to pay benefits. ▪ Scenario analysis should cover a range of outcomes, including both short-term and long-term assessments. ▪ The PRA has separately issued climate change stress scenarios which larger insurers will be expected to complete by 30 September 2019.

Risk Management

Firms should address the financial risks from climate change through existing risk management frameworks, adopting a strategic approach to measure, monitor, manage and report on these exposures.

Required actions	▪ Firms will need to provide management information to the Board and relevant sub-committees generated through a range of quantitative and qualitative tools. ▪ All material exposures to financial risks from climate change should be summarised in the Own Risk and Solvency Assessment. ▪ Firms will need to evidence plans for managing all material financial risks from climate change, including mitigation techniques (in keeping with the Prudent Person Principle requirements).

Governance

The board should understand and assess the financial risks from climate change, and to be able to address and oversee these risks as part of overall business strategy and risk appetite.

Required actions	▪ Firms will need to assign clear roles to its Board, sub-committees and an appropriate SMF holder. ▪ Firms will need to evidence how they monitor and measure financial risks from climate change. ▪ Risk appetite statements will need to include limits and thresholds with respect to the level of financial risk they are willing to bear.

Disclosure

Firms should consider the need for, and relevance of, further Pillar 3 disclosures to enhance transparency of the approach to managing the financial risks from climate change.

Required actions	▪ Firms are expected to develop and maintain an appropriate approach to climate related disclosure. ▪ Firms should seek to evolve this over time and prepare for the possibility of further disclosure requirements in other regulatory jurisdictions.

What next?

Whilst the requirements of this new supervisory statement are undoubtedly wide-ranging, the PRA notes that it expects firms' responses to be proportionate to the "nature, scale and complexity" of its business.

It also acknowledges that firms' approaches – as well as the PRA's own – will continue to develop over time in line with a growing level of expertise in this field. Additional guidance should therefore be expected in due course.

"It is better to be roughly right now, not precisely right when it is too late"

Sarah Breeden of the PRA on the growing need to tackle climate risk, April 2019

Nonetheless this should not be interpreted as a justification for inaction in the near term. The requirements laid out are effective immediately and the PRA will begin to expect evidence of progress during supervisory meetings within the next few months.

As a starting point, we believe firms will need to:

- Assign roles and responsibilities across their business for tackling climate change risk.
- Develop an internal body of expertise on climate risk.
- Identify where climate risk arises within the firm's balance sheet.
- Start formulating appropriate stress and scenario tests.

For larger firms, there will be an additional requirement to perform climate-related stress testing by the end of Q3 2019. The PRA have prescribed draft scenarios for this purpose which may serve as a useful starting point for firms when developing their own assumptions.

Whilst firms will need time to develop their internal processes, those most effective in tackling the risks posed by climate change will be those who begin early.

Hymans Robertson has a wealth of experience across all matters relating to Investment and ALM, including Responsible Investment. We would be delighted to support you in understanding your exposure to the financial risks from climate change.

If you would like to discuss with one of our specialists, please get in touch

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