Institute
and Faculty
of Actuaries

CP 23/18: Enhancing banks' and insurers' approaches to managing the financial risks from climate change

IFoA response to Prudential Regulation Authority

15 January 2019

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries (IFoA) is a royal chartered, not-for-profit, professional body. We represent and regulate over 32,000 actuaries worldwide, and oversee their education at all stages of qualification and development throughout their careers.

We strive to act in the public interest by speaking out on issues where actuaries have the expertise to provide analysis and insight on public policy issues. To fulfil the requirements of our Charter, the IFoA maintains a Public Affairs function, which represents the views of the profession to Government, policymakers, regulators and other stakeholders, in order to shape public policy.

Actuarial science is founded on mathematical and statistical techniques used in insurance, pension fund management and investment. Actuaries provide commercial, financial and prudential advice on the management of assets and liabilities, particularly over the long term, and this long term view is reflected in our approach to analysing policy developments. A rigorous examination system, programme of continuous professional development and a professional code of conduct supports high standards and reflects the significant role of the profession in society.

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Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

15 January 2019

Dear Sir/Madam

IFoA response to CP23/18: Enhancing banks' and insurers' approaches to managing the financial risks from climate change

1. The Institute and Faculty of Actuaries (IFoA) is active in the climate change space, recognising that there are material financial risks arising directly from climate change and from measures taken to avoid or mitigate it. Climate change considerations will thus affect actuarial work through both physical and transition risks, with impacts in all the areas in which actuaries operate. Furthermore, actuaries can significantly impact climate change mitigation through advice on investment portfolios and the allocation of capital, clearly supporting the IFoA's vision to "serve the public interest". As a result, the IFoA issued a profession-wide risk alert in May 2017, encouraging all actuaries to take appropriate account of climate change in their work.

2. The IFoA therefore welcomes CP23/18 and the opportunity to respond to *Enhancing banks' and insurers' approaches to managing the financial risks from climate change*. Our Resource and Environment, Risk Management, Life Insurance and General Insurance Boards have been involved in the drafting of this response. Members of these Boards have considerable experience across the main areas discussed in the CP, namely governance, risk management, scenario analysis and disclosure.

General comments

3. The IFoA believes that CP23/18 is a very useful document in helping to put the financial risks from climate change at the forefront of insurers' agendas, which is especially important at a time when firms are also grappling with a range of other major issues such as IFRS 17 and Brexit.

4. We believe that a cultural shift is necessary for firms to engage with climate change risk and to assess the corresponding potential financial impacts. We think that such a shift is compatible with a degree of scepticism among firms about the extent of climate change. Once they accept that climate change is a serious prospect, they can then consider the potential consequences – not least the real prospect that revised risk exposures may impact on valuations of both assets and liabilities. The PRA's proposals are helpful in this respect: they go beyond corporate social responsibility and firms being aware of their carbon footprint, and extend to how firms understand, manage and disclose the impact of climate change risks on their business models and strategy.

5. Linked to this, is how challenging it is to gain a good level of understanding of the risks associated with climate change. Generalising, unless an individual has paid careful attention to the topic and undertaken a reasonable amount of research, they are unlikely to understand the levels of risk

associated with atmospheric carbon dioxide levels and other greenhouse gases, and the urgency with which our society needs to address this[1]. Further, there may be limited understanding of just how severe the implications of an additional 1°C of warming could be for the stability of both human and natural systems[2]. If senior management in firms do not have a broad understanding of the underlying nature of climate change, then this may increase the challenge of managing associated financial risks effectively.

6. We believe that the PRA should frame its expectations such that firms will regard financial risks from climate change as tangible: not just as emerging risks, but as risk exposures which should be quantified now. Many firms focus on the top 4-5 risks they face and financial risks arising from climate change are not usually key focus areas. However, if firms have taken time to consider, qualitatively and ultimately quantitatively, the financial impact of such risks then they will have a much deeper understanding of it. They can then consider the specific implications for their firm – such as what it means for their investment strategy.

7. A number of factors can influence firms' behaviour: regulatory pressure (firms may struggle to resource an issue unless they have to); the actions of their immediate peers; and possibly 'fear of missing out'. However, we believe that climate change risk is gaining prominence on insurers' agendas.

Detailed comments

8. We have focussed our detailed comments on the draft Supervisory Statement (SS) within CP23/18.

<u>Section 1 - Introduction</u>

9. We agree with the proposed scope of the SS.

<u>Section 2 - Financial Risks from Climate Change</u>

10. We believe that the SS is helpful in differentiating between acute and chronic, long-term physical risks.

11. We note that this section describes two primary sources of climate change financial risks: physical and transition. However, liability risk is only mentioned as a by-product of these two sources. We suggest that liability risk should be highlighted in its own right in order to alert firms to this potential area of significant risk exposure.

<u>Section 3 – A strategic approach to managing the financial risks from climate change</u>

12. We agree with the PRA's comments in 3.1 that a firm's response to the financial risks from climate change will be proportionate to its size and complexity and will also mature over time. At the same time, in order to promote real change across the whole range of firms, the PRA will need to ensure (as it also says in 3.1) that it can measure and monitor firms' progress effectively. In considering the PRA's approach to this, we would support a balance between consistency and taking account of firms' differences, and an avoidance of 'box ticking'.

13. We recognise that the PRA cannot lead firms, but we believe there are ways it could help them to respond in a meaningful way to the SS, for example providing a set of questions firms should consider.

14. Another possibility would be to share potential scenarios and potential areas which could be impacted as a consequence. This would address the risk that firms may use a wide variety of

[1] "Trajectories of the Earth System in the Anthropocene", Steffen et al, 2018 https://www.pnas.org/content/115/33/8252

[2] IPCC, Special report on Global Warming of 1.5°C https://www.ipcc.ch/sr15/

scenarios, which may not be consistent, either in their qualitative nature, their timescales or their notional temperature goals. However, we suggest such scenarios may quickly become the effective default scenarios for the industry, creating undue influence and systemic vulnerability to events outside those scenarios, as well as reducing broader thoughtfulness and engagement by firms. We believe it might be more effective for the PRA to consider providing resources to help firms prepare (such as frameworks and workshops), rather than to specify certain parameters.

Governance

15. In 3.4, we support the reference to the potential for more than one Senior Management Function to be responsible for climate change financial risk identification and management. Climate change impacts will likely affect more than one area within a firm, and it is important that climate change risk is not just the domain of the Chief Risk Officer. Some firms may see relevant roles sitting within their first line function.

16. Where possible, we support having a designated climate change ‘champion’ within a firm, provided they have sufficient influence to drive real change. This may not be practical for some small firms, while in some larger companies there could be a concern that the champion is seen as having extreme views which get discounted.

Risk management

17. We note that the SS applies to all firms, not only to larger firms. We agree with this approach, given that it is important for all firms to consider their financial exposure to climate change risk. We think the SS will help those working in smaller firms who wish to ensure that robust climate risk management is in place, by making their position come across as mainstream and credible within their organisation.

Scenario analysis

18. We support the PRA's expectation for firms to conduct scenario analysis to determine the impact of the financial risks arising from climate change on their overall risk profile and business strategy, and to inform their strategic planning.

19. A recent IFoA working paper concludes that narrative scenarios can be helpful given the limited research available on the macroeconomic impacts of climate change, especially on inflation and interest rates, and the uncertainty this can create[3]. Having a narrative description of the scenarios is key to developing users’ understanding of climate risks and supporting any parameterisation.

20. We would encourage the PRA to state specifically in the draft SS that they expect a range of appropriate time horizons to be used in scenario analysis, including longer time horizons in line with liabilities which for some firms may extend beyond 20 years. Even where liabilities are more short term, we believe that scenarios should extend beyond firms’ normal planning horizons, albeit that the scenarios are likely to become more qualitative than quantitative as the time horizon increases.

21. The PRA should look to ensure where possible that there is international comparability in the approaches firms use to devise their scenarios.

22. We note the specific reference in 3.15 to a 2°C global temperature increase. This is a valid individual scenario, but the full set of scenarios should consider the whole range of potential outcomes, and should avoid any ‘anchoring’ to 2°C, which could be regarded as optimistic, given the real possibility of a greater increase based on current models.

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[3] https://www.actuaries.org.uk/news-and-insights/news/implications-climate-change-challenge-or-opportunity (see 2nd link from this article)

23. We would encourage the PRA to consider future outputs of the United Nations Environment Program Finance Initiative's (UNEPFI's) Principles for Sustainable Insurance (PSI), of which we are a supporting institution, to determine whether there is merit to encourage their use by regulated firms. UNEPFI launched a partnership with 16 of the world's largest insurers to develop a new generation of climate change risk assessment tools.

24. We would also point to the Principles of Responsible Investment's work on the Inevitable Policy Response[4] to climate change as another high profile global collaborative initiative focused on development of qualitative scenarios with accompanying quantification of these.

25. In general, climate risk quantification is an area where there is significant development currently with a variety of specialist providers active in the market. Services available now include both stock specific analyses of physical and transition risks, as well as macro-economic estimates of the impact of different climate scenarios on various economic indicators.

Disclosure

26. We welcome the PRA's expectation that firms will reflect upon whether existing disclosure requirements are adequate, or whether additional disclosures are necessary to enhance the firm's transparency. The IFoA considers effective and thoughtful disclosure to be essential to understanding the financial risks of climate change. However we consider that corporate disclosures currently fail to provide sufficiently comprehensive, accurate and consistent information on sustainability risks for the purpose of enabling investors to make adequately informed decisions.

27. We are a listed supporter of the TCFD, which the SS highlights as a disclosure initiative that firms should consider using. Its recommendations provide a framework for companies to deliver forward-looking disclosures about climate-related financial risks and opportunities and we believe that disclosures made in line with the TCFD recommendations will enable investors to make better-informed decisions. Using frameworks such as TCFD, we believe firms can develop an understanding of good practice with respect to climate change risk disclosure over the next few years.

28. The last sentence of paragraph 3.21 of the SS states: "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 note that the PRA does not have specific powers in this regard, although it may have an interest in making sure that firms are seeking sufficient information to make informed investment decisions.

29. If you would like to discuss any of the points raised please contact Matthew Levine (Matthew.Levine@actuaries.org.uk / 020 7632 1489) in the first instance.

Yours sincerely,

Jules Constantinou
President, Institute and Faculty of Actuaries

[4] https://www.unpri.org/climate-change/the-inevitable-policy-response-to-climate-change/3578.article