Climate change poses new, significant and complex challenges for banks

Questions Boards should be asking

Banks must act now on climate change in order to ensure the financial resilience of the bank in the medium to long term, meet new and evolving stakeholder expectations, and harness opportunities created by the transition to a lower carbon economy.

Regulators across the globe are moving to set out their expectations on climate risk management, and strategy setting. Banks in Europe face several deadlines this year. 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 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. Regulators expect Boards, in particular non-executive directors, to pose robust challenge and provide effective oversight of their bank's identification and management of climate risk. The themes explored below help Boards navigate this difficult environment and meet regulators' expectations.

The challenges which set climate risk apart

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.

Data

There is a scarcity of relevant, granular, and forward-looking data. Even though there is an abundance of climate ratings, divergent methodologies across vendors mean that the ratings assigned to each counterparty can vary significantly.

Predicting future risks

Climate risks are highly uncertain and non-linear in their propagation, and can affect multiple risk categories simultaneously. Historical loss experience cannot be used to estimate the risks.

Due diligence

Due diligence in relation to climate risk is required on all (material) counterparties banks are transacting with across the value chain. This may need to cover their clients' overall strategic resilience to climate risks and critically their supply chains.

Expertise

There is a lack of expertise on, and understanding of, climate risk across the banking industry at all levels of seniority, as the mix of skills, knowledge and experience required is new and complex.

Time horizon

Climate risks are expected to materialise over a long time horizon. This requires an extension of traditional bank strategic planning horizons, which are typically three to five years.

Proportionality

There is uncertainty about the appropriate governance structures required for different sized firms, and the level of detail needed to meet disclosure standards effectively.

Overcoming the challenges on climate risk

Key themes Boards should consider

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	• Augment existing Board sub-committees or new committees and working groups • Include objectives associated with achieving the firm's climate targets in variable remuneration for executives • Ensure there is sufficient breadth of knowledge, skills and experience within the organisation through training or recruitment
Strategy and business model To ensure long-term resilience, the bank must address climate risk within its strategy	• Embed climate-related considerations into the bank's strategy with a clear path towards meeting global targets e.g. net zero emissions, or sustainable development goals • Look at multiple time horizons, to demonstrate how the business will evolve in response to the move to a more sustainable economy • Set specific strategic objectives, limits and key performance indicators in relation to climate change
Risk management Climate risk must be integrated fully into the risk management framework, from setting risk appetite, through risk identification, to risk mitigation	• Develop a risk identification process which covers the full range of climate risks to which the bank is exposed, with sufficient sophistication to support the identification of new risks as they arise • Enhance existing risk appetite statements and metrics to include factors related to climate risk • Develop metrics across varying time horizons, to reflect the nature of the risk identified • Develop an approach for defining climate risk in the risk taxonomy, i.e. as a cross-cutting risk or a new primary/principal risk.
Scenario analysis Scenario analysis is an important tool for understanding the scale of exposures to climate risk, and for strategic planning	• Develop capabilities and infrastructure within the bank to conduct robust scenario analysis • Align scenario analysis with risk management objectives and wider climate strategy • Take management actions based on the results of scenario analysis
Liability risk Banks must ensure that liability risks in relation to market disclosures and conduct are managed effectively	• Address any gaps or deficiencies in climate disclosures • Align the bank's product and service offering with its strategy on climate change • To guard against "greenwashing" and other conduct and liability risks, ensure there is a robust controls framework in place for the products the bank offers or deals in – across valuation, modelling, accounting, due diligence, product governance, suitability, and disclosure

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These themes are explored in further detail in our report Climate change and banks | Questions Boards should be asking.

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