



Climate change: financial institutions and their stakeholders - PRA expectations and UNEP Principles for Responsible Banking

From 15 October 2019, UK banks and insurers are expected to have initial plans in place to address the expectations set out in the Prudential Regulation Authority's (PRA) Supervisory Statement (SS) 3/19, 'Enhancing banks' and insurers' approaches to managing the financial risks from climate change' and to have submitted an updated Senior Management Function (SMF) form. Under the rules, SMFs will have responsibility for identifying and managing climate-related risks and the SS sets out four key expectations that financial institutions are expected to adopt in their strategic approach to managing climate risk.

Also addressing the issue of managing climate change risk, on 22 September 2019 (to coincide with the UN Climate Action Summit in New York) the UN Environment Programme announced the launch of the Principles for Responsible Banking. 130 banks worldwide have signed up to the Principles which include a commitment to align their business strategies with the goals of the 2015 Paris Agreement on Climate Change and the UN Sustainable Development Goals (SDGs).

These developments will be of considerable interest to the stakeholders of financial institutions and insurers. The underlying economies which rely on capital from these institutions and insurers may wish to pay careful attention. These developments are part of a process pursuant to which we can expect changes (perhaps profound) to the destinations and terms of capital.

PRA SS 3/19

Following consultation, the PRA issued SS 3/19 in final form in April 2019, giving banks and insurers six months to put initial measures in place.

The SS outlines the financial risks from climate change (physical and transitional) which the regulator considers require firms to adopt a strategic approach to risk management. While the PRA recognises that the nature, size and complexity of a business will be relevant to the measures that it adopts, the SS sets out four key expectations:

1. **Governance:** firms are expected to have clear roles and responsibilities at board level, including allocating responsibility for identifying and managing financial risks from climate change to the most appropriate existing SMF(s). Those responsibilities must be included in the SMF(s)'s Statement of Responsibilities and boards are expected to ensure that adequate resources and sufficient expertise are devoted to managing climate change risk.
2. **Risk management:** firms should address the financial risks from climate change through their existing risk management frameworks, in line with board-approved risk appetite statements, while recognising that the nature of the risks requires a strategic approach. Exposure to climate change risk should be evidenced in written risk management policies, management information and board risk reports.
3. **Scenario analysis:** the PRA expects firms to carry out scenario analysis to assess the impact of financial risks from climate change on their business strategies. A range of outcomes should be addressed reflecting different transition paths to a low-carbon economy and the scenarios used to assess the impact on firms' solvency and liquidity.
4. **Disclosure:** firms are expected to develop and maintain an appropriate approach to disclosure, including disclosing how climate-related financial risks are integrated into their governance and risk management processes.



UNEP's Principles for Responsible Banking

Signatory banks have also committed to implementing the UN Environment Programme's Principles for Responsible Banking which were formally launched on 22 September 2019. A document setting out Key Steps to be Implemented by Signatories and a Reporting and Self-Assessment Template were published alongside the Principles and together these comprise the Principles for Responsible Banking Framework Documents. Accompanying the Framework Documents, the UNEP has published a Guidance Document containing non-binding guidance for signatories on achieving the Principles.

The Principles Signature Document sets out six principles:

1. **Alignment:** signatory banks commit to aligning their business strategies to be consistent with and contribute to needs and goals contained in the SDGs, the Paris Agreement on Climate Change and other relevant frameworks (for example, the UN Guiding Principles on Business and Human Rights).

The Guidance Document notes that banks are required to set out how they are aligning their business strategies with relevant frameworks and be clear about how they intend to contribute to the achievement of the frameworks' goals. Boards of directors and appropriate departments and committees should have a 'comprehensive understanding' of the relevant frameworks and, focusing on those most relevant to their operating context, banks should use climate targets and SDGs as a framework to evaluate and adapt their business strategies.

2. **Impact & Target Setting:** signatories commit to increasing positive impacts on people and the environment resulting from their activities, products and services (at the same time reducing negative impacts and managing risks). Targets must be set and published.

The key steps that signatories must undertake are to conduct an impact analysis (the Guidance Document states that this should be an analysis of the bank's impacts on society, the environment and the economy), set SMART (specific, measurable, achievable, relevant and time-bound) targets to address at least two of the significant impacts that are identified, put in place plans to implement the targets and monitor progress. Targets should be linked to the SDGs, Paris Climate Agreement and other relevant frameworks and the Guidance Document gives as examples working with clients and customers, and expanding or reducing a bank's exposure to certain sectors. There should be frequent reports on progress to the board of directors and executive team and achieving targets for sustainability objectives should be linked to remuneration and incentive systems.

3. **Clients & Customers:** signatories will work with clients and customers to encourage sustainable practices while at the same time enabling economic activities that create shared prosperity for current and future generations.

The Principle commits banks to adopting policies and practices that promote responsible conduct, encourage sustainable practices, and enable sustainable economic activities on the part of their customers. Steps that can be taken include raising awareness among customers and developing products and services to encourage and support sustainable business models, technologies, practices, and lifestyles. The Guidance Document suggests, for example, that incentives such as preferential interest rates and rewards programmes could be offered to customers to encourage them to make more sustainable investments and financial decisions.

4. **Stakeholders:** signatories commit to consulting, engaging and partnering with relevant stakeholders.

Banks should identify key external stakeholders (such as investors, governments, communities and non-profit organisations) and work with them to achieve climate change goals.



5. **Governance & Culture:** commitment to the Principles will be implemented through effective governance and a culture of responsible banking.

The Guidance Document sets out steps for banks to take to comply with the Principle, including having clear and specific roles and responsibilities both at board level and across the bank's functions, building internal expertise through training or recruiting specialists, and establishing appropriate policies, systems and procedures. Banks' lending policies should be aligned with scientific approaches and, for employees, sustainability targets should be embedded into remuneration and performance management systems.

6. **Transparency & Accountability:** implementation of the Principles will be reviewed periodically and signatories will be transparent about and accountable for their positive and negative impacts and contribution to society's goals.

Signatory banks must provide information on their implementation of the Principles within 18 months of becoming a signatory and annually thereafter. As well as using the Reporting and Self-Assessment Template, banks should disclose their compliance with the Principles as part of their existing reporting procedures, for example in annual reports, sustainability reports or on their website.

Comment

The expectations in the PRA's SS 3/19 and the Principles for Responsible Banking build upon and, to some extent, harmonise existing regional and global initiatives to reorient capital flows towards environmentally sustainable economic activities, via the European Union's Action Plan on Sustainable Finance and the Market-led Task Force on Climate-related Financial Disclosures.

They also reflect a growing concern of national and international regulatory and policy bodies that climate change risk has not been appropriately recognised by financial institutions' business strategy. For instance, last year in its report 'Transition in thinking: The impact of climate change on the UK banking sector', the PRA found that only 10% of banks were adopting a strategic, long-term view of financial risks. The new PRA rules and UN Principles, with their emphasis on the role of boards of directors and SMFs, will undoubtedly see climate risk rise up the agenda. Of course any change of this nature will be of interest to the underlying economies as recipients of capital from financial institutions. As the financial institutions review their strategic risks and positions, it is conceivable that profound shifts in the destinations and terms of capital may occur (and perhaps over a shorter timescale than many imagine currently).

Financial institutions and insurers need to be mindful of the growing physical, transitional and liability risks that they face and plan appropriately how to deal with them. The number of climate change related claims is increasing as NGOs and affected communities start to look at ways to force those operating in carbon intensive industries to move into new cleaner and sustainable sectors and/or to pay for long term issues arising out of carbon emissions. In the future, claims may also be seen against those financial institutions (or other companies) that do not plan for the transition appropriately, potentially leading to an impact on companies' values and share prices and giving rise to class action opportunities for claimant lawyers.

Further reading:

[PRA Supervisory Statement 3/19](#)

[Principles for Responsible Banking](#)

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