BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Rt Hon Mel Stride MP
House of Commons
London
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Dear Chair

I would like to thank you for the opportunity to give evidence at the Treasury Select Committee on 30 September as part of your enquiry into 'Decarbonisation and Green Finance'.

As requested, this letter responds to two questions raised during the session: what progress has been made in embedding climate risk into PRA regulated firms' operations; and the role of the Senior Manager Regime in this process. I have also included responses to two questions received following the session, pertaining to the impact from exiting the EU and sustainable linked loans.

As explained in our evidence to the Committee, we expect that the economy will experience some combination of the physical and transition risks associated with climate change over the coming decades and that these will in turn impact the creditworthiness of individuals and companies, and the valuation of assets across the system. We therefore consider it vital that PRA-regulated firms consider and act on climate risk in their operations.

To help facilitate this, in April 2019 the PRA issued a Supervisory Statement (SS3/19[1]) on 'Enhancing banks' and insurers' approaches to managing the financial risks from climate change. SS3/19 set out our expectations for banks, building societies and insurers to govern, manage and disclose the financial risks from climate change. In setting this, we recognised that meeting the expectations would be challenging for firms and that this was the first time such expectations had been set by a global regulator.

What progress has been made in embedding climate risk into PRA regulated firms' operations and the role of the Senior Manager Regime in this process

It is of course the responsibility of each firm's board and management to manage the firm prudently, consistent with its safety and soundness, thereby contributing to the continued stability of the financial system. To support this, the PRA together with the FCA developed the Senior Managers Regime ("SMR"), which strengthens the link between seniority and accountability through a clear allocation of responsibilities to a firm's most senior decision-makers. Since its implementation in 2016, we believe that this regime has provided us with a flexible tool that promotes better prudential outcomes across a range of areas by ensuring that supervisors can, where appropriate, link risk mitigation actions to responsible individuals. Given the importance of understanding climate risks, firms were informed as part of SS3/19 that they would need to

[1] https://www.bankofengland.co.uk/prudential-regulation/publication/2019/enhancing-banks-and-insurers-approaches-to-managing-the-financial-risks-from-climate-change-ss

identify a Senior Manager responsible for climate risk by October 2019. In line with the PRA's expectations, firms' allocation of SMR responsibilities have been to the most senior executives in their organisations: over half of firms allocated responsibility to the CRO; after which the most commonly assigned executive was the CFO and then CEO. The majority of firms have concentrated responsibility within a single role-holder – in other cases, the PRA has typically sought explanations from firms where more than one holder has been identified to ensure that responsibility is not fragmented. Overall, we are confident that the SMR regime has been appropriately adopted by firms for climate risk and that it will help to drive the regulatory outcomes that we expect to see.

Following the issuance of SS3/19, the PRA has worked closely particularly with the largest firms to ensure that they are working to meet its expectations at an appropriate speed. This has included meetings with relevant Senior Managers, within which firms' implementation plans have been discussed. We note that many of these firms have now reviewed asset classes and assessed the potential impact of climate risk on their balance sheets. That said, areas that are more complex and require longer lead times such as the development of risk metrics and disclosures are in earlier stages. This work has allowed the PRA to provide sector-wide feedback on firms' implementation of SS3/19 within a Dear CEO letter from Sam Woods in July 2020.[2] This feedback sets out examples of good practice, and those areas where improvement is required.

Our current view is that whilst some firms have made more progress than others, the overall rate of embedding SS3/19 is acceptable. Whilst the PRA's focus to date has necessarily been on the largest firms, going forward additional focus will be given to understanding SS3/19 progress within smaller firms - where a proportionate approach to climate risks is expected.

The PRA did not initially set a date by which it expected its SS3/19 to be embedded. In light of the progress above and the need for firms to understand the current and future risks to which they are exposed, the July 2020 Dear CEO letter also set an end-2021 date for our expectations to be fully embedded. This is again ambitious and goes further than other global supervisors. To support this, the PRA is taking action to address barriers to progress:

- **Data gaps:** A key challenge for firms in understanding climate risks is the large number of data gaps. We have made it clear that this should not stall progress and that we are open to firms using educated judgements and assumptions where gaps exist. The PRA will work with firms to understand where the most material judgements and assumptions are required;

- **Scenario analysis:** As the past will be no indication of the future for climate risks, the PRA has emphasised the importance of conducting scenario analysis as a tool to identify risks in a variety of potential future climate outcomes. We have set out our intention to conduct a climate exploratory scenario exercise for our largest banks and insurers in 2021 to evaluate the risks posed to individual firms and the system as a whole, and have published our proposed approach in a Discussion Paper[3]. Through the Network for Greening the Financial System (NGFS), we have also been driving the development of a suite of reference scenarios to help firms undertake scenario analysis and to encourage a consistent international approach.[4]

- **Industry guidance:** We have convened, jointly with the FCA, the Climate Financial Risk Forum ("CFRF") through which industry can collaboratively address the barriers and challenges. Their first guides were published in June[5] and will help firms progress towards meeting supervisory expectations. The CFRF met in July to discuss how its next stage of work can most effectively assist firms;

[2] https://www.bankofengland.co.uk/prudential-regulation/letter/2020/managing-the-financial-risks-from-climate-change
[3] https://www.bankofengland.co.uk/paper/2019/biennial-exploratory-scenario-climate-change-discussion-paper
[4] https://www.ngfs.net/en/communique-de-presse/ngfs-publishes-first-set-climate-scenarios-forward-looking-climate-risks-assessment-alongside-user
[5] https://www.bankofengland.co.uk/climate-change/climate-financial-risk-forum

- **PRA capacity and expectations:** We will continue to develop our capacity to define what good climate risk management looks like and to upskill supervision teams to ensure they have the tools critically to evaluate and challenge firms' implementation. Where appropriate, our evolving view on expectations and tools will be communicated to firms; and

- **Proportionality:** We are taking a proportionate approach to smaller firms, who may have particular vulnerabilities due to geographic or sectoral concentrations. We will continue to work with firms and associations to provide views on how proportionate approaches to climate risks can be developed.

I understand the Committee has raised two further questions.

Does the UK's exit from the EU offer any opportunities in terms of better regulation to meet net zero, and what recommendations would you make to Government?

When the transition period ends, the UK will gain full control over its regulatory rulebook. HM Treasury and UK regulators could introduce new rules or tailor existing rules to suit the specifics of the UK market and UK objectives. In the context of climate change, collaboration with international partners is crucial, as it is a global issue that crosses borders. That is why even as we exit the transition period we will continue to work closely with regulators in Europe and abroad - for example through the Network for Greening the Financial System (NGFS) and other international fora. Through these groups, we are sharing knowledge and best practice among regulators, which can help inform the future pathway of UK climate-related financial regulation.

More broadly, we continue to work closely with HMG and UK regulators on climate-related issues. For example, we have been working with the UK Government-Regulator TCFD Taskforce established as part of the UK's Green Finance Strategy[6] to explore mandatory disclosure requirements across the economy. We are committed to continuing this work to ensure we arrive at high quality, decision useful, comparable disclosures of climate risk. Such disclosure would help make clear the current and future climate impact of companies' activities so that governments can make informed policy choices, investors can make informed investments, and consumers can make informed spending decisions. The Taskforce will shortly publish its interim report, setting out actions to be taken by taskforce members over the coming years.

Post Covid-19, what role do you think sustainability-linked loans can play in changing corporate behaviour and 'building back better', and how can the Bank support innovative loan structures?

Markets in green finance continue to develop and innovate across a wide range of instruments, ranging from sovereign issued green bonds to sustainability-linked loans for corporates. Given the scale of investment required for the economy to transition to net zero, such developments are obviously critical.

Sustainability-linked loans have seen an increase in popularity in recent years following the development of industry standards such as the Sustainability Linked Loan Principles. When well designed, with transparent and sufficiently ambitious targets, they can help to incentivise and support businesses transition towards net-zero emissions. Providing the right financial incentives for companies in the real economy to adjust their business models is something both government and financial markets could do; it is a key component of achieving the economy-wide transition that we need to reach net-zero. Alongside green bonds and other initiatives (for example asset allocation strategies) designed to ensure that investment is appropriately directed, sustainability-linked loans can play an important role in helping the financial system support the economy-wide transition to net zero.

The Bank is engaging regularly with market participants on all these developments through private discussions and expert-industry groups such as the Green Finance Institute. A recent speech by my

[6] https://www.gov.uk/government/publications/green-finance-strategy

colleague Andrew Hauser summarised some of the findings of this ongoing work.[7] We have worked with industry and the FCA through the CFRF to publish an overview of innovation in climate finance. And the Bank continues to work with other supervisors and central banks around the world to monitor developments in green finance through the NGFS. Finally, and as we discussed when I appeared before the Committee last month, the Bank is considering how it should further develop management of its own balance sheet to take these issues into account, thereby using its strength and influence as a market participant to drive change, where doing so is consistent with its mandates.

I trust this information meets your needs but please do not hesitate to contact me should you require clarification or further information.

Yours faithfully

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[7] https://www.bankofengland.co.uk/speech/2020/andrew-hauser-the-investment-association-viewpoint