



Learning by doing: Climate risk & your 2021 ICAAP

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Introduction

As we roll into 2021, financial services firms that run an internal capital adequacy assessment process (“ICAAP”) will be reviewing their risk registers for adverse risk factors and scenarios to anchor the assessment on.¹ In the current unstable macro-financial environment, the long list of risks that merit attention in the ICAAP continues to grow. COVID-19 macroeconomic implications, BREXIT, low interest rates are prominent contenders for ICAAP inclusion, as are several others. Some firms hold the view that climate risks lack the same immediacy and without complete guidance on how to run climate change risk analysis, there is ambiguity about the level of analysis to be included in the ICAAP. However, we make the case that there is urgency to the climate change agenda with growing regulatory expectation, which merits the prioritisation of climate risks in the 2021 ICAAP in some depth.

The urgency of climate risk

Together, the many financial risks from climate change, which we will refer to below as *climate risks*, encapsulate a cluster of risks. The acute, climate-related hazards -- the floods, the extreme temperatures, the forest fires, etc.—are most commonly associated with climate change. Nevertheless, climate risks should also cover knock-on macro-financial risks, rapid change in behavioural preferences, policy risks, technology shocks (referred to as transition risks) and litigation risks. This large array of cross-cutting climate risks needs urgent attention from both a business and regulatory perspective. The 2021 ICAAP is one arena in which to wrestle with the different challenges these present, even if this is done on a tactical basis.

In its annual [Global Risks Report](#), which surveys business leaders, NGOs and academics for top threats facing the world by likelihood and impact, the World Economic Forum identifies environmental risks as number one by impact and number two by likelihood. Environmental risks, which include climate considerations, have now dominated the top ten position in the list for four consecutive years.

¹ The ICAAP comments in this note are directly primarily at banks and building societies that are dual regulated by the PRA and FCA and European firms subject to the ICAAP process. However, there are business reasons for IFPRU firms that run an ICAAP analysis to also give regard to climate risk.

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Regulatory Expectation on Climate Risk Management

The regularity of this finding itself provides compelling business reason for ICAAP consideration. But the urgency on ICAAP prioritisation has been further elevated by growing regulatory expectation. The European and UK regulators are guiding firms to include the financial impact from climate change risk in the ICAAP. The [‘ECB Report on banks’ ICAAP practices](#) and ‘Supervisory Statements [31/15](#) and [3/19](#)’ both comment on this. It can be expected to be part of the Supervisory Review and Evaluation Process (SREP) conversation between banks and the supervisory authority.

Further, in July 2020, the PRA’s [“Dear CEO” letter](#) further clarified that the expectation is for ‘climate-related financial risk to be integrated within our full range of supervisory activities, including the 2021 BES exercise’. Andrew Bailey, the current Bank of England Governor, reiterated this most recently in his November 9, 2020 speech entitled [‘Time to push ahead on tackling climate change’](#) by commenting: “As we have set out in our supervisory expectations, firms must assess how climate risks could impact their business and review whether additional capital needs to be held against this”.

These regulatory developments point to value of giving climate risks strong consideration for the 2021 ICAAP. The climate materiality risk assessment, the scenario analysis, the financial impact analysis with commentary on implications, if any, for capital will generate regulatory confidence on the institution’s progress on climate risk management. For banks that are in scope for the ‘BES’ it would serve as a “dry run.”² For banks that are not, the 2021 ICAPP would be an opportunity to showcase the firm’s climate risk readiness, ahead of the PRA recommended end-2021 timeline.

Done well, good ICAAP analysis:

- ✓ Identifies key risks to the business;
- ✓ Comments on their materiality along different dimensions – such as likelihood, impact and velocity;
- ✓ Includes scenario analysis that illustrates how some or all of the identified risks might play out over the planning horizon;
- ✓ Provides supporting qualitative and quantitative impact analysis, typically under both a base and select stress scenarios;
- ✓ Outlines the bank’s response to the risks, especially under the stress scenario; and, in doing so
- ✓ Demonstrates the bank’s overall risk management capabilities and the consequent implications for risk strategy and capitalisation.
- ✓ The BES is an abbreviation for the Bank of England’s *biennial exploratory scenario* stress test, run circa once every two years by the largest UK banks and building societies.

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Six typical concerns

Banks and other financial services firms that produce ICAAPs would recognise these design principles. In fact, firms reporting to the PRA or European Regulatory Authorities on their ICAAP will be tracking the increased regulatory expectations on climate risk, notably the ECB and PRA comments in recent months, as clarified in the PRA's [Dear CEO letter](#) and [ECB's report on banks' ICAAP practices](#). Despite these regulatory drivers, some institutions still have reservations about prioritising climate risk in their ICAAPs. These concerns range from doubts about general readiness to the possibility of capital surprises through SREP add-ons. We outline **six typical concerns**:

1. **The typical horizons for climate risk are not relevant to my institution.** Climate risk analysis, despite its many facets, may not generate material findings for the bank's portfolio, especially over the three to five-year ICAAP business planning horizon;
2. **It's too early , the climate hazards have yet to be internally risk-mapped to the bank's portfolio** and, before this activity is completed, other practical aspects of climate risk management cannot be properly progressed within the 2021 ICAAP timeline;
3. **There is insufficient data for climate risk analysis;**
4. **Climate scenarios are too complex, posing selection, design and scenario generation challenges**, falling outside current capabilities for scenario generation and stress testing infrastructure;
5. **Risk models that would underpin climate risk analysis are yet to be readied;**
6. **Would better risk identification necessarily imply higher capital requirements?**

Each of the above concerns about climate risk inclusion in the ICAAP deserves fuller discussion. There is of course, no single correct answer that is valid for all institutions. Each bank or FS institution preparing an ICAAP would need to weigh up its own benefits against the efforts involved. But the pointers below should help. We address each in turn briefly below.

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Addressing each of the 6 concerns



1. The typical horizons for climate risk are not relevant to my institution

Banks that have already expressed interest in ICAAP climate risk inclusion still fail to fully appreciate this. The concerns come from two broad and different directions:

- (i) the maturity profile and;
- (ii) the velocity at which certain climate risks play out.

The portfolio maturity profile might, for example, be heavily at the short end, possibly with the weighted average maturity less than a year. What relevance does average increase of 2°C over several years have? So goes the reasoning. On this, our guidance would be to conduct a systematic mapping of all climate hazards – physical, transition and liability risks. The typical trade-off between transition and physical risks in a climate emergency are such that a in a well-selected scenario if physical risks do not impact, there is every chance transition risks would through a disorderly transition. As to the implications of some (physical) climate risks that typically play out over the much longer term, these too can be addressed. There are methods to compress the effect on customer behaviours, supply chains or capital market valuations so as to be relevant to the shorter, more condensed three to five-year planning horizon of the ICAAP. The ECB is keen for firms to integrate ESG risks into their ICAAP not purely for capitalisation purposes, rather to encourage them to think long-term and assess the viability and sustainability of their business model over a three- to five-year horizon.



2. It's too early to be including climate risks in my ICAAP. These have yet to be internally risk-mapped to the bank's portfolio

The counter here is simply a practical one. The ICAAP provides a sufficiently high-profile channel to conduct a preliminary risk identification and mapping exercise. Rather than wait for all the ducks to align and postpone till when supporting climate risk processes are enabled, consider the ICAAP as the channel for accelerating those risk assessments and mapping.

Climate risk inclusion in the ICAAP could mobilise pending discussions around resultant risk management implications. The risk appetite framework, risk policies and processes would get the necessary push. With a bit of planning, the commitment to address climate risk in the ICAAP would act as a catalyst for such activity. Also, regulators may not be expecting perfection in the first pass, rather incremental progress on climate change risk analysis.



3. Climate-related data is inadequate

There isn't sufficient high-quality data to progress meaningful climate risk analysis. For example, carbon emissions data is not available across the firm's value chain, indeed often for not much of it. The forward-looking element of climate change and the unprecedented scenarios make this a special challenge, more so than say credit cycle forecasting, and this is recognised. The industry is waking up to this challenge, the list and number of supporting data sources are widening but the data is yet to go through more standardisation. As evidence, there is a plethora of climate-related ratings for corporates. The regulators recognise this challenge. Nevertheless, there is an expectation for banks to not stall climate risk analysis until all the data emerges and settles; even a mix of qualitative and quantitative analyses around climate risk in the ICAAP would be considered acceptable progress.

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4. Climate scenarios are complex, posing scenario design and generation challenges for this cycle

Typically ICAAP risk analysis would be supported by validated and well-embedded risk models at the larger banks. These might be they credit, market or operational risk models or indeed other risk categories. For climate risk, the models may not have been developed and validated. So the doubt stems from progressing scenario generation, risk modelling etc. without validation. The guide here may be (model) risk materiality. If models have been enhanced to address the most material climate risks, they should be leveraged. A mix of hybrid qualitative and quantitative approaches provides a tactical alternative. The outcome from such hybrid ICAAP analysis might be it forces the internal thinking on where and what potential model enhancements and development need urgent development.



5. Risk models that would underpin climate risk analysis are yet to be readied

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6. Would better risk identification necessarily imply higher capital requirements?

Will uncovering further climate risk implications automatically cost the institution more in terms of capital add-ons? The supervisory authorities have yet to finalise firm-level guidance around capital implications. Andrew Bailey, the Bank of England governor, has said the results will not be used to size firms' capital buffers but they should themselves think of the implied near-term capital requirements. The 2021 SREP process may be too early to have concerns directly about capital increments. Supervisory authorities are still navigating towards a balanced outcome -- one that incentivises good risk management rather than penalises it. But they also need to address the climate emergency and accelerate the response across the financial services industry. To this end, most would prefer institutions to accept the responsibility of conducting *some* interim climate self-assessment -- and the sooner the better. Initially supervisory authorities may only take note of each institution's materiality assessment, scenario selection and the high-level approach to impact analysis. By the same token, going through the exercise once, and by expanding on the thinking around climate risk in the ICAAP, institutions may be better positioned to shape the regulatory thinking on this. In the SREP feedback that follows an ICAAP submission, banks that have actually elaborated on climate risk in their ICAAPs would be in a stronger position. Firms can then guide their supervisory authorities on the material and residual risks, thus leading to a better SREP dialogue for all. They will also be better positioned to respond in the future should additional capital requirements be a natural consequence of their climate risk profile.

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Concluding Comments

The above rationalises the prioritisation of climate risk for the next ICAAP, covering six typical concerns. In practice each firm will need to weigh up how much ground it wants to cover in its first climate-inclusive ICAAP and how far its resources allow it to go. Institutions have different business models, varied risk infrastructure, and different resource pools they can tap into to support climate risk and the ICAAP. So the final decision on *when* and *how far to go* may not be the same for all. The overall regulatory expectation in the UK and Europe is however very clear. When it comes to climate risk management, the case for *learning by doing* is now very compelling. The 2021 ICAAP is just the vehicle for that.

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