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Climate Financial Risk Forum publishes guidance for firms on climate-related risks and opportunities

Governance and Impact – Part of the Horizon Scanning series

On 29 June 2020, the Climate Financial Risk Form (CFRF) published guidance to help FCA- and PRA-regulated firms of all sizes understand the risks and opportunities that arise from the climate emergency and to support firms in integrating these risks and opportunities into their own risk, strategy and decision-making processes.

The guidance provides practical recommendations across four climate-related (CR) areas: risk management; scenario analysis; disclosures; and innovation. Although the guidance is not mandatory, firms are expected to take it into account from now on.

What does the guidance cover?

The CFRF's guidance is very broad in scope and covers the following four areas (each in a separate chapter):

Risk management

This chapter covers many aspects of risk management, including governance, risk appetite, tools, training and challenges. It includes real-world examples of good CR risk management, as well as advice on how firms can embed CR factors within existing risk management processes. In particular, the guidance advises firms to assess CR risks to an appropriate timetable, as the time horizon typically used by firms for

What is the Climate Financial Risk Forum?

The **CFRF** was set up jointly by the PRA and the FCA in March 2019. The CFRF's goal is to produce practical tools and recommendations for firms to help them respond to CR financial risks and to capture opportunities arising from the climate emergency.

While co-chaired by representatives of the FCA and PRA, the CFRF is an industry-led forum, bringing together senior representatives from 17 firms across the financial sector, including banks, insurers and asset managers. Membership also includes wider industry participants, including the Green Finance Institute and the London Stock Exchange, to ensure that a broad range of perspectives are represented.

At its inception, the CFRF established four technical working groups on risk management, scenario analysis, disclosures and innovation. Each of these working groups is chaired by a CFRF member and seeks contributions from 10-15 member participants (drawn from a significant number of regulated entities, trade bodies and other interested parties from across the UK).

The CFRF guide published in June comprises four chapters - each prepared by one of the working groups - plus a summary chapter that has been prepared by the FCA and PRA.

assessing risk is likely to be much shorter than the timespan over which climate risks will evolve.

Scenario analysis

As the guidance says, "*making a start with scenario analysis can be a bit daunting given the number of assumptions, data and decisions required*". It therefore recommends a three-stage approach to help firms get started: first, to identify the firm's material exposures to climate risk and determine what it wants to achieve through scenario analysis; second, to decide the type of scenarios and risk metrics to be considered; and third, to define (and refine) how impacts are translated into financial metrics used by the firm in decision-making.

Generally, the guidance recommends that firms should start by considering simple '*what if?*' scenarios, and then introduce more complexity over time. CR scenario analysis is acknowledged to be iterative and cyclical, with the real-life impacts of CR decisions being used to refine and update the CR scenario assumptions that were involved in the original decision-making process.

As the data, practices and technologies that underlie scenario analysis are developing quickly, this is an area where firms are expected to be particularly agile and respond to the latest developments.

Disclosures

The disclosure chapter of the guidance builds on the disclosure framework of the Taskforce on Climate-related Financial Disclosures (*TCFD*), as well as other statutory and non-statutory disclosure requirements, providing examples of best practice disclosures in the sector. The guidance emphasises the need for effective CR disclosure as the bedrock which enables corporates, investors and consumers to make informed CR decisions, and encourages firms to consider the adequacy of their disclosures from the perspectives of different stakeholders. It includes specific guidance on disclosures that could be made by asset managers, banks and insurers.

In terms of timescale, firms should aim to make high level, mainly qualitative, disclosures by mid-2021, and more quantitative disclosures by the end of 2022. Again, though, the key message to firms is start simple and add complexity over time.

Innovation

The innovation chapter focuses both on the commercial opportunities presented by the climate emergency, and on the role of financial institutions in responding to it. Recommendations include the development of new investment vehicles and products (e.g. transition bonds and green infrastructure funds), the deployment of capital into CR products and services which can support the transition to a net-zero economy, and collaboration with local authorities to support the development of net-zero carbon projects.

Is the guidance mandatory?

The guidance is not mandatory, nor is it regulatory guidance (indeed, there is an express disclaimer that the recommendations and views set out in the guide do not necessarily represent the views of the regulators). Instead, the guide sets out current best practice, written by industry, for industry. As the chapter on

disclosures puts it, *"it does not provide a mandatory 'to do' list for firms to follow; rather, it gives guidance on what firms could be doing".*

The guidance is also intended to be read in conjunction with other CR frameworks and initiatives, such as the Principles of Responsible Investment, Banking and Insurance, and the TCFD disclosure framework.

Although it is not a regulatory publication, the guidance should be viewed as complementary to the FCA's and PRA's regulatory initiatives in this space, which include:

- the PRA's supervisory statement on CR risks (SS3/19) and the FCA's feedback statement on climate change and green finance (FS 19/6), both published last year;

- the Bank of England's announcement of its 2021 biennial exploratory scenario, the world's first bottom-up system-wide climate stress-test, to assess the resilience of banks, insurers and other financial institutions to CR risks (although this initiative has since been pushed back as a result of the Coronavirus pandemic); and

- the FCA's consultation on the introduction of CR disclosures to the Listing Rules on a 'comply or explain' basis for premium-listed commercial companies (CP20/3 - see our separate briefing on this consultation here).

Against this backdrop, the guide should be viewed as a practical and accessible set of guidelines that will help firms to put themselves in the best position to comply with future regulatory requirements.

Firms have already been put on notice that the introduction of meaningful CR regulation is a matter of when, not if.

Indeed, the guide recognises that best practice will continue to evolve over time and that, while the CFRF has made significant strides in sharing good practice among the financial services industry in the UK, the regulatory environment will continue to develop over the coming years.

How will the guidance impact your organisation?

For financial institutions, the guidance is directly relevant. However, the guidance recognises that:

- different aspects will be more or less relevant to firms in different sectors;

- it should be applied proportionately - i.e. depending on size and resources of the firm, as well as the firm's exposure to CR risks and its experience of managing those risks; and

- not everything can be implemented at once: as noted above, firms should start simple and add complexity over time.

Although not directly relevant, organisations outside the financial sector may still find some of the guidance useful for the management of their own CR risks. Furthermore, they may also find themselves being impacted by the guidance indirectly. For example:

- banks may introduce CR lending criteria, which may affect the availability of financing (or, at least,

the rate at which funds can be borrowed); and

- CR factors may affect the price of obtaining business-essential insurance.

And because the guidance – or relevant parts of it – is likely to be emulated by other regulators, organisations in other regulated sectors can use it to get a head start in addressing the CR risks and opportunities that they face in their own industries.

If you would like further information about this topic, please speak to your usual Slaughter and May contact.

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