ICAEW
REPRESENTATION 11/20

ICAEW REPRESENTATION TO THE 2021 BIENNIAL EXPLORATORY SCENARIO ON THE FINANCIAL RISKS FROM CLIMATE CHANGE

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ICAEW welcomes the discussion paper (DP) on *The 2021 biennial exploratory scenario on the financial risks from climate change* in which the Bank of England ("the Bank") explores the use of the biennial exploratory scenario to assess the financial risks from climate change. We particularly applaud the efforts the Banks makes in collecting feedback at the early stages of planning the stress test. The DP is available from this link.

Developing stress-tests for large banks and insurers for climate change related financial risks, combining climate risk variables with macrofinancial variables, is a laudable step in the achievement of holistic risk management. However, we believe that in order to fulfil the role that the financial services industry has a vision must be developed that includes the dynamics of the broader system. The introduction of the bold measures described in the DP provides a great opportunity to explore the additional inclusion of nature-related financial risks in a timely manner.

This response of 18 March 2020 has been prepared by the ICAEW Financial Services Faculty. As a leading centre for thought leadership on financial services, the Faculty brings together different interests and is responsible for representations on behalf of ICAEW on governance, regulation, risk management, auditing and reporting issues facing the financial services sector. The Faculty draws on the expertise of its members and more than 25,000 ICAEW members involved in financial services.

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MAJOR POINTS

1. The proposed process is truly exploratory and should enable both the Bank and the financial institutions to use the BES as a learning exercise. Consulting relevant shareholders early enough and repeatedly at different stages of the stress will help design the test in a way that it would provide helpful information and assist institutions in managing and mitigating these risks.
2. Developing stress-tests for large banks and insurers concerning climate-related financial risks, combining climate risk variables with macrofinancial variables, is a laudable step in the achievement of holistic risk management.
3. However, in order to fulfil the role that the financial services industry has in acting in service to UK households and businesses, awareness of risks associated with the produced, social, human, and natural capital stocks and flows that generate a healthy economy, in essential. A vision must be developed that not only gazes further, but also includes the dynamics of the broader system.
4. Interactions between banks and insurers will be assessed in the 2021 BES, with a view to achieving the beginnings of a system-level approach. Reporting on regional, and sectoral, levels will allow for appropriate granular levels of assessment. The introduction of these bold measures provides a great opportunity to explore the additional inclusion of nature-related financial risks in a timely manner. These risks bear similar characteristics and carry similar impacts in the short, medium, and long term. Not only do they carry these impacts, but they also highlight the financial services' dependency on natural resources, human resources, and other underrepresented forms of capital, and capital flows.
5. The framework that has been proposed in the 2021 BES discussion paper, includes multiple variables across climate and economy and provides an arena in which it is no longer a challenge to include multiple, additional, medium to long-term systemic risks to our financial service industry, and economy as a whole. These include, for example, effects of natural capital stock and flow degradation, including that of land and soil, deforestation, biodiversity loss, nutrient accumulation, and air pollution, leading to potential catastrophic effects on the structure and resilience of our ecosystems, stretching their ability to provide services to our societies and economies.
6. In a year in which high-level policy, concerning natural capital and biodiversity, will be discussed at several global events (Convention on Biological Diversity CoP 15, IUCN World Congress, UNGA and Biodiversity Summit, UNFCCC CoP 26) it is essential for the UK financial services industry to understand the size and extent of its exposure to global systemic risks. This must look beyond only climate change exposures and look to include all financial industry risks exposed to natural, social, human, and financial impacts and dependencies.

RESPONSE TO SPECIFIC QUESTIONS

In our opinion some of the questions are aimed at specifically at banks and/or insurers therefore we are unable to provide a meaningful response to these.

Key features of the 2021 BES

Q1 Are there areas of the financial system that should be represented in the 2021 BES that are not captured by the proposed participation?

7. We believe that the proposed design of participation in the BES would assist the Bank capture and analyse the risk faced by the firms as well as the system as a whole. The provided set of data and scenarios fundamentally different from the traditional stress testing methodologies will compel firms to start from scratch and view this process with a fresh perspective. They will have to collect, analyse and interpret all data and some case look for alternatives when needed.

8. Testing banks and insurers at the same time and within the same process will allow the Bank to form a view of the resilience of the financial system as a whole. The climate related financial risks can be explored without having to cope with an additional process, although of course the level of required data will be significantly higher.
9. Making the scenario information available for smaller banks and insurers would allow them to complete the exercise as part of their own scenario analysis work. This should help them understand the regulatory expectations and assist in the long run in developing sector specific scenarios and consistent comparable disclosures as well. It could also provide a base for benchmarking in the future.
10. The DP proposes testing the large banks and insurers. It would be informative if the Bank could give an indication of the proportion of the financial system being tested in this manner.

Scenario narratives

Q3 Are there any other scenarios that the Bank should be testing as part of the 2021 BES?

11. The proposed approach suggests 3 different scenarios: early policy action, late policy action and no additional policy action. While further details could elaborate on these specific scenarios (for example specify the temperature increase attached to these basic propositions) keeping the scenarios as simple as possible is important. While the Bank will want to be able to compare the results provided by the participants, they need to be able to have the flexibility to interpret the requirements.
12. Specifying the actual temperature increase or at least a range in the no additional policy action scenario would probably be still helpful in quantifying the projected results. "….global average temperatures increase substantially by 2080…" could allow for significantly different interpretation by participants impairing the comparability of the results.
13. For the late policy scenario it would be instrumental for the Bank to illustrate what happened in comparable economies when sudden changes had a huge effect (for example Cuba's Special Period when the economy collapsed primarily due to the sudden halt of the Soviet energy supplies). The illustration might be helpful to participants to fully appreciate the potential downfalls. The current economic upheaval following the COVID-19 outbreak also shows the devastating effects of sudden disruption in economic activities – although it is way too early to tell how relevant the comparison could be to a late policy action.

Q4 Do the scenario timeframes strike the right balance between allowing a full assessment of these risks while also being tractable for firms' modelling?

14. While the horizon goes far into the future, the 5-year repeat submission requirement should keep participants close enough to their regular business planning horizon.
15. We believe that assuming that the more material risks anticipated in the period from 2050 to 2080 occur by 2050 is a reasonable simplification without damaging the results. Estimates and forecasts beyond 30 years will have very significant uncertainties anyway, therefore the proposed assumption is on the prudent side.
16. However, we would point out that modelling the 30-year timeframe will be very challenging for both banks and insurers. While the discussion paper describes the process in a fairly simple manner, we are not certain that it would land the same way with participants.
17. It would be helpful if during this feedback period banks and insurers would be specific about the challenges they anticipate in gathering data and would propose alternatives. This would allow the Bank to set the requirements in a realistic way.

Scenario specification

Q5 Does the scenario specification adequately capture the risks in each scenario? Are there additional risk channels or scenario variables that should be considered as part of the BES?

18. The DP suggests building the specification of scenario variables on the Network for Greening the Financial System's (NGFS) reference scenarios due to be published in April 2020. This

should ensure that in future further tests and more importantly tests conducted internationally will have a consistent baseline. Consultation at a later stage on the detailed specification of the variables should assist the Bank to refine the requirements and allow banks and insurers to feed back using their sector specific expertise. Also allow them to take changes already on the way into consideration.

Q7 Are there particular external sources to calibrate physical and transition risk impacts that the Bank should consider when calibrating the scenario variables?

19. We recommend the work of Four Twenty Seven (link). Their science-driven risk analytics deliver unique insights into the economic impacts of climate change by providing climate risk scores for listed securities, site-specific risk assessments for real assets and intelligence services for scenario analysis, market opportunities, and resilience strategies.

