*Supporting the Financial Services industry with risk management and advanced analytics*

# Managing climate change risk: From Board to BAU

## Part 2: Risk Management & Governance

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### *Introduction*

In Part 1 of our climate change series[1], we discussed the various climate-related regulatory changes faced by life insurance companies in conjunction with their expected associated implementation timelines. In the period since we released Part 1, significant progress has been made by both firms and regulators to improve the measures in place to mitigate climate-related risks and cultivate the industry's awareness of the need to act.

Firstly, publications such as the Intergovernmental Panel on Climate Change's (IPCC) 6th Assessment Report[2] mean it can now be stated, with an increasingly high degree of confidence, that financial risk posed by climate change is likely to produce unprecedented challenges in the coming years.

Secondly, the 2021 United Nations Climate Change Conference (COP26) in Glasgow, saw the UK become the first G20 nation to confirm the enforcement of mandatory climate reporting[3], such that all UK-based firms must report in line with the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD). Around 1300 large companies will be impacted from April 2022, with the remainder of firms being brought into scope by 2025.

The TCFD's recommendations include four key pillars that firms will have to follow and provide evidence of reporting compliance. These include:

- Governance
- Strategy
- Risk management
- Targets & metrics

Enhancement of risk management and governance frameworks will be key in ensuring insurers appropriately consider climate-related financial risk which, in time, may emerge as the most material risk to an organisation. It is vital that adequate thought is afforded to developing governance structures that provide a clear view of the potential impacts of this risk. This article seeks to articulate a possible approach to forming a suitable risk management and governance arrangement, while emphasising why it is particularly impactful in the life insurance industry.

[1] Insurance: Part One - Insuring the path to a greener future — 4most Credit Risk Analytics Consultancy (4-most.co.uk)
[2] https://www.ipcc.ch/assessment-report/ar6/
[3] https://www.gov.uk/government/news/uk-to-enshrine-mandatory-climate-disclosures-for-largest-companies-in-law

*Why is it so important?*

Put simply, governance and risk management cover two of the four TCFD pillars; consequently, they're fundamental in assuring a life insurance firm adheres to disclosure requirements. Likewise, it is almost impossible to recall a time where an emerging risk, with a time horizon stretching far into the future, has emitted a conceivable potential to change everything we take for granted and yet, seemingly continues to rely on only embryonic thinking.

Through careful consideration and implementation of suitably stringent governance processes, the introduction of such practises should lead to the following:

- Sufficient awareness, attention and challenge allocated from oversight committees
- Allocation of suitable resource and responsibility across the organisational structure
- A means to identify, assess and measure the risks to the long-term strategy and sustainability of the business
- Establishment of expertise and necessary knowledge in decision-making bodies to adequately scrutinise climate-related risks

Across developed economies there are different governance structures adopted and, regardless of how they may be formulated, they should serve as an important risk management tool if they possess a few essential characteristics:

- Independence from day-to-day decision-making
- Capability to challenge strategic direction
- Coordination across the business and industry
- Flexibility to adapt to an evolving risk class and developing best practice

In the UK, life insurers adopt hierarchical governance structures, led by appointed Boards of Directors (BoD), to provide independent oversight of performance and Executive Management (EM) that is responsible for developing strategy. All life insurers endeavour to adequately scrutinise decisions through an appropriate governance regime – yet this responsibility does not simply reside inside the remit of those sitting on a Board; all employees ought to carry some level of accountability for adherence to governance. All these roles, from a Board through to individual business units, are vital to ensure that strategic decisions are subject to relevant controls which aim to mitigate the financial risk emanating from climate change.

*Revolution or evolution of existing practice?*

One-way firms can begin their "climate change journey" is by taking a top-down view of their business, reviewing their existing governance structures and operating models to achieve the most effective climate change framework for meeting this new challenge. As they move further through their journey and establish a mature governance structure, focus will necessarily shift towards the finer details of identifying and building specific capabilities.

A sensible starting point when assessing a governance structure is to consider whether it can deliver the requirements of the regulator. The letter issued by the PRA to CEOs on 1st July 2020[4], stated the following guidelines to improve a firm's governance frameworks:

1. *Consistent communication:* Climate change related financial risk must be a consistent topic of discussion at Board level and tools must be developed to communicate business decisions at regular intervals.
2. *Defined strategic response:* A firm's response strategy must be defined clearly, including a detailed understanding of the physical and transition risk present. Special consideration should be given to the interactions between multiple lines of business, sectors, and geographies.

Figure 1 presents a governance structure where Board-level governance cascades through the organisation with appropriate committees and designated individuals. This top-down structure, with the BoD performing an oversight role, ensures climate risks are considered by those responsible for setting the strategy. The role of the layers below, where individual committees are allocated specific roles and responsibilities, is to communicate information on climate-related risks.

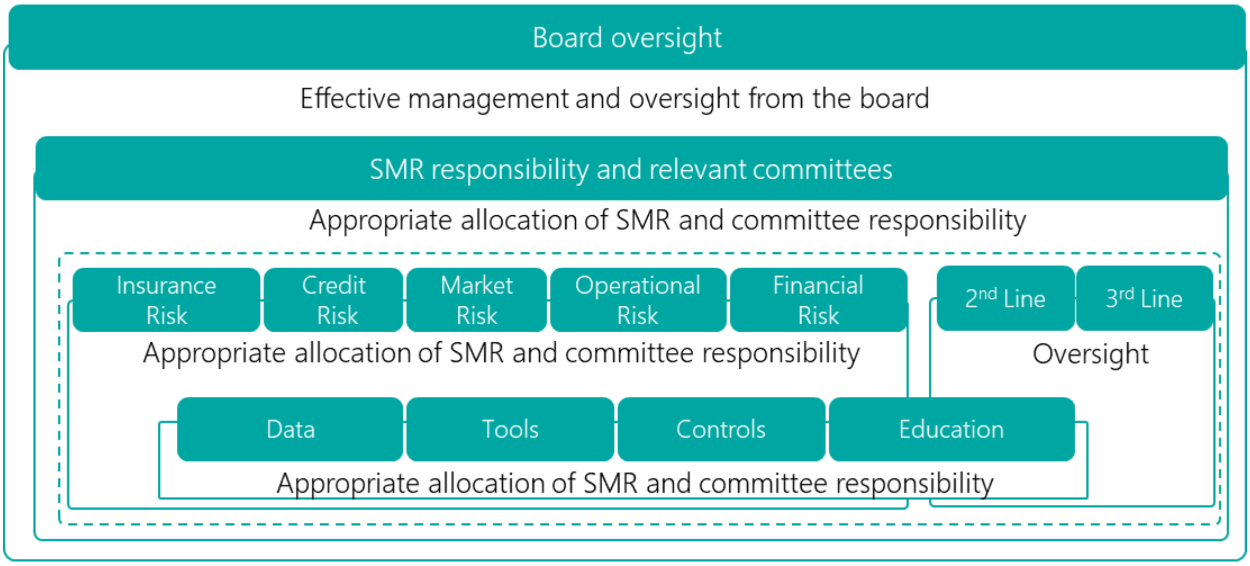


*Figure 1 – A common governance structure for large firms*

Insurers' governance structures are well established and the success of these structures in managing today's risks set a strong precedent for their continued use in managing climate change risk. These structures should not require material change; however, climate-related risks do present a new challenge. It is important to ensure frameworks are thoroughly assessed to

[4] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2020/managing-the-financial-risks-from-climate-change.pdf?la=en&hash=A6B4DD1BE45B2762900F54B2F5BF2F99FA448424

ensure this new risk is appropriately considered, with a timely flow of management information throughout the business.

As a firm delves deeper into each level and assesses the responsibilities and activities within, it is likely gaps will start to emerge. Figure 2 lists some changes that would need to be considered within a climate change framework.

**Climate change management objectives**

Meeting current and incoming regulations

Robust measurement and monitoring of key climate metrics (vs. targets)

Setting operational and investment targets for reaching 'net-zero' carbon emissions

Ensuring all employees have the knowledge and tools to play their part in managing climate-related risks

Taking advantage of climate-related opportunities

Development of short and long-term strategies in response to climate change (and the publication of these to all stakeholders)

**Governing principles and roles and responsibilities**

Identification of climate change risk exposure

Periodic risk assessment

Risk appetite statements, goals, and targets

Origination and portfolio management activities

Climate risk data and management

Climate change model development and maintenance

Climate risk mitigation and diversification techniques

Periodic review of the framework

Culture and training

*Figure 2 - Considerations for inclusion in a climate change risk management framework*

### *Board oversight*

As our understanding of climate change grows, so should the way insurance firms prepare for it. The first question a BoD should be asking themselves is:

> *"Are we suitably equipped, and do we possess the required expertise to understand and manage this risk?"*

Many of these risks are new for firms and will require the BoD to build or acquire knowledge. Firms should be ensuring members of the Board are properly trained or specially appointed, such that there is a sufficient level of climate competence across the BoD.

With knowledge and expertise in place, the BoD and EM must examine and approve the strategy. They should consider how climate-related financial risks may interact with the strategy and objectives already in place. Firms are not just responsible for trying to limit their own exposure to changes in climate; they may, in future, be held accountable for their own actions in contributing to climate change. Any long-term strategic plan should consider the existing risks and emergence of new risks in the future – not simply how to extract value from climate change opportunities or protect themselves against new risks – but also to consider their own role in moving the world towards a greener economy and helping to meet future climate change targets. It is important to note that climate predictions are long-term, given the impacts of climate change could stretch 20-80+ years into the future. However, a short-term strategy must be in place to complement any long-term strategy, this could include initial planning to confront issues over the next 1-5 years, as well as creating processes and systems to allow the measurement and monitoring of internal and external climate metrics. Without these in place, it will be impossible for a firm to track their climate performance over time and remediate if performance is not meeting defined strategic thresholds.

Table 1 identifies some recent strategic statements made by insurers and proposes how climate change considerations might be factored into these. It is important that any aspect of the strategy embraced to address climate-related risk is translated into meaningful sustainable finance commitments and included in a firm's risk appetite.

| Strategic vision | Considerations |
|---|---|
| Improve the lives of our customers | How can insurers help customers manage the impact of climate change on their everyday lives?<br>Who is the target market, how will different markets be impacted?<br>Insurers should be considering:<br>• Increased incidence of disease due to temperature changes<br>• Consumer preference for sustainable products<br>• Wealth creation and management of green personal savings<br>• A growing vulnerable population and the need to overhaul social care provision<br>• Changing consumer priorities/expectations |
| Build a better society for the future | Can insurers be trusted to put the interests of society ahead of their own financial gain?<br>Firms could look to invest in the real economy with an ESG focus:<br>• Affordable/social housing<br>• Commercial/retail real estate<br>• Infrastructure projects (e.g. renewable energy)<br>• Green assets (e.g. green bonds)<br>Minimising environmental impacts through working and investing with suppliers who embed sustainable practices within their business.<br>Providing policyholders with the opportunity to invest in responsibly managed funds. |
| Deliver long term value to shareholders | Insurers should consider how they can continue to extract value from their existing portfolios while also:<br>• Eliminating exposure to companies that do not comply with carbon emission targets and are not providing evidence they will hit future targets<br>• Decarbonising investment portfolios in the aim to be net-zero (or lower) carbon in the future<br>• Supporting innovative data analytics and climate change reporting to identify profitable and sustainable asset classes<br>• Committing to transitioning their own operations to a 'net-zero' carbon status by a certain date |

*Table 1 - How climate change may impact a firm's strategy*

The collective understanding of climate change is developing constantly, with new research and information being released regularly, such as the IPCC's AR6 report (mentioned at the start of this article), analysing:

- the causes of climate change
- the effects of climate change
- the possible mitigations
- new regulatory requirements

As with any complex topic, those responsible for understanding and managing climate change risk (i.e. a BoD) should continue to grow and improve their own awareness by consuming expert briefings and internal analysis, whilst consistently reviewing a firm's position in line with these developments. To ensure this happens, the Board Committees' Terms of Reference should be updated to consider climate risk and where necessary, relevant responsibilities and targets should be assigned to monitor and track its progression.

### *Senior management responsibility & committee structure*

Moving beyond oversight and responsibility for a firm's strategy, the CEO and BoD need support from senior management. This is best established by assigning responsibility to a specialist committee, overseen by members of a risk function and with representation from across a business, to help identify and focus on the sustainability and climate-related aspects of the business. There should also be one overall risk owner, such as the CRO, who will lead and be responsible for the committee's decisions.

These committees form the foundation on which a firm builds effective management of climate change risk. They will be responsible for:

- Agreeing the frameworks to continually identify, manage, mitigate, and monitor climate-related risks.
- Reporting back to the BoD and EM regarding ESG risks, opportunities and progress made against defined goals/objectives.
    - Examples of objectives were included in 'Figure 2' above
    - Remediation must be proposed where performance against goals and objectives is identified as unsatisfactory. This will need to be assessed on an annual basis and success will need to be measured against a defined set of quantitative and qualitative metrics.
- Setting a culture of awareness and ensuring staff across the business are appropriately trained to manage these risks.
    - For example, through tactical interventions to improve employee knowledge of climate-related risks and increase their familiarity with the obstacles of funding green infrastructure and research; or
    - Employees could be offered an enhanced employer contribution when investing their monthly pension contributions in ESG funds.
- Establishing processes to measure climate management progress relative to quantifiable benchmarks or best practice.
    - Insurers can lean on regulators and consultancies to provide industry best practice, appropriate benchmarks, and support with mandatory disclosures.
- Acting where operations or strategy fall short of overarching climate change targets.
    - Overarching targets must be supported by a series of shorter-term goals and milestones aligned to individual business units. Incentives can be utilised to encourage business units to perform well.
    - Accountability of senior risk owners is key - where targets are not met owners must provide appropriate actions to remedy the situation.

*Risk management*

Despite the governance structures proposed, risk management is not just a senior management concern. Firms should allocate further responsibility to individual business units whose duty it is to carry out the day-to-day role of identifying, managing, monitoring, and reporting climate risks.

Many firms apply the "3 lines of defence" approach to risk management and, as per many other risks, each line has their own role to play in the management of climate change risk. These responsibilities need to be clarified to ensure ownership and accountability in respect of climate change. An example split of these responsibilities is shown below:

**First Line: BAU**

- The primary responsibility of owning and managing the climate change risks that impact the day-to-day operations of the business.
- Responsible for the design, implementation and running of the tools and processes required to help monitor business exposure to climate change.
- Carry out climate assessments when considering existing portfolios and new business (assets and liabilities).

**Second Line: Risk Management Function**

- Responsible for establishing the frameworks, policies, tools, and techniques needed to support the management of climate change risks.
- Research and develop ways in which the firm can support its transition to a more sustainable business with reduced climate-related financial impacts.
- Deliver training and embed behaviours across the business.
- Scenario development to facilitate impact analysis.

**Third Line: Internal Audit**

- Performing internal audits of first and second line functions' activities.
- To guarantee, through validation, that climate change risks are being identified, managed and mitigated by the other areas of the firm.
- Investigate past risk management shortcomings and suggest methods to reduce the likelihood of these having an adverse effect on the management of climate change risk in the future.

*Tools & infrastructure*

For a firm to successfully manage its risks they not only need the right people, but also the right tools and infrastructure to support them in both the identification of new risks and the monitoring of known risks. Without investing in the required tools, the employees and the business will be set up to fail. Figure 3 highlights a few areas that need to be considered.

**Data**

- **Quality** - Data must be of sufficient quality for monitoring and assessing climate change risks. A model and its results are only as good as the data going in. Poor quality data could lead to missed risks or an incorrect assessment of the current position.
- **Complete** - Firms should begin by considering what output they need in order to better understand their risks. By better understanding the goal, they can work backwards building a clear view of the data they need across their asset & liability portfolios to aid strong climate risk management.
- **Types** - Companies will be faimiliar with handling asset and liability data but may need to expand into climate modelling and locational modelling. This will require new types of data they may not be used to handling or validating.

**Models**

- **Scenarios** - Firms need to consider scenarios over the medium-to-long term, to analyse the sustainability of their business over the same horizons and any potentially emerging climate risks that are not immediately threatening.
- **Scenario types** - Companies will need to establish ways of converting climate change scenarios into financial scenarios. Additionally, they will need to develop models to understand downstream implications of climate change risk realisations.
- **Output granularity** - At what level do model outputs need to be scrutinised? To what extent will risks at the portfolio level be monitored?
- **Auditable** - Models need to be well documented and understood. Strong governance procedures for outputs will be essential for validating their use when monitoring climate risk.

**Communication**

- **Supporting decision making** - Only useful and relevant information needs to be communicated. The insurance industry is already in a position of information overload. Firms should be careful to only produce and communicate information that supports their decision making process. Too much excess information or irrelevant output could lead to confusion and poor decisions being made, as well as potentially hiding key information.
- **Approachable** - Output needs to be clean and in an easily approachable format. Those responsible for using results will not appreciate ambiguity or needing to spend time interpreting information.
- **Easily sourced** - To prevent information asymmteries across different areas of the business, output should be available and accessible to all those who need it.

*Figure 3 - Infrastructure requirements for supporting climate change risk management*

## *20 second takeaway*

As firms prepare to manage climate change and any associated mandatory climate disclosures, a readiness review of current risk management processes is required. Many insurers have already established robust governance structures which can easily be extended to support the management of climate change risk. However, work is still required to refine risk management structures, implement specific frameworks, build expertise and extend measurement capabilities.

Firms can benefit from quickly assigning clear responsibilities in respect of climate-related risks and obtaining relevant resources to take on the challenge of managing it. They will need to consider changes across the business, starting with strategy and moving down to the day-to-day roles of the 3 lines of defence. People across the business will need training in these new risks to ensure they are sufficiently knowledgeable and capable of using tools the business has introduced to manage them.

4most has significant experience in developing capabilities to robustly address regulatory change. Our team can support a firm in performing a readiness review, in which we would identify the specific functions in need of development to ensure climate risks are managed effectively. The structure of our readiness review is fully aligned to the BoE’s requirements and will provide actionable recommendations tailored to existing governance structures, processes, and methodologies to ensure a business is ready for the challenge of dealing with climate-related financial risk - from Board to BAU.