Mr. Sam Woods, Deputy Governor and CEO
Prudential Regulation Authority

Ms Sarah Breeden, Deputy Governor
Financial Stability

Bank of England
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By email:
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sarah.breeden@bankofengland.co.uk

29th January 2024

Dear Mr. Woods and Ms Breeden,

Re: Role of investors in promoting capital adequacy in the face of climate change

We are writing to you as a group of long-term investors in your capacities as Deputy Governors at the Bank of England responsible for safety and soundness of the UK banking sector and for Financial Stability. We do so because we are concerned by the potential for increasing systemic risk to the banking sector from climate change, and to offer some suggestions for strengthening the necessary market discipline as foreseen under Pillar 3 of the Basel Framework.

We recognise, of course, that the risks posed by climate change to financial stability are global and we will therefore be writing to other prudential regulators. We would also like to underline from the start that we applaud the Bank of England's leadership in promoting climate resilience, and that of other institutions with whom it works, such as the Financial Stability Board and the Network of Central Banks for Greening the Financial System (NGFS).

Notwithstanding this leadership, we have the following concerns:

- Inadequate accounting and audit disclosures by banks specifying how material climate factors have been incorporated, compounded by a lack of information on capital adequacy in the face of plausible yet severe climate and transition risks, adversely impacting the functioning of Pillar 3 of the Basel Framework[1].
- Climate modelling that is understating risks, particularly with regard to the impact of physical climate risk but also with respect to transition risks in the face of the accelerating roll out of clean technology[2].
- Slow progress in moving towards enhanced capital requirements to protect against systemic climate risks that are unlikely to be ever fully captured in banks' accounting.

[1]This issue was also flagged in PRA guidance sent to Bank CEOs and CFOs in October 2022 (https://www.bankofengland.co.uk/prudential-regulation/letter/2022/october/managing-climate-related-financial-risks), which underlined: "*[t]he PRA considers that timely incorporation of climate risk in accounting valuations is important in ensuring the safety and soundness of PRA-authorised firms."* and set clear expectations for banks' "*disclosures that help market participants understand the linkage between firms' climate-related disclosures and the impact on their financial statements and Pillar 3 reporting."*

[2] See for instance https://actuaries.org.uk/media/qeydewmk/the-emperor-s-new-climate-scenarios.pdf

As long-term investors, we are keen to promote more effective climate risk management and would like to suggest the following potential actions for you to consider:

- Explicit guidance to banks that they use severe but plausible climate scenarios that consider the latest scientific understanding on tipping points and other non-linearities;
- Requirements for banks to disclose the key conclusions from regulatory climate stress-testing exercises they have undertaken, including implications for capital adequacy in more severe climate and transition scenarios; and
- Proactive enforcement of existing accounting and audit rules to ensure that material climate risks are properly reflected in banks' financial statements (particularly with relation to banks' Expected Credit Loss assumptions) and auditor reports[3] [4].

Alongside the above steps, we also agree with the Bank of England's conclusion in its March 2023 report that when it comes to climate risks*, "capital frameworks require a more forward-looking approach than used for many other risks*", and would support further work around how regulatory capital requirements could better reflect climate risks to build system resilience[5]. Where capital required is calibrated to the quality of individual bank's risk management, this would provide a strong incentive for banks to step up their management of climate risks. International coordination on regulatory capital will naturally be important to ensure a level playing field.

For almost a decade, the Bank of England has been at the forefront of addressing the financial risks from climate change. We are keen to see the Bank maintain its leadership and play a proactive role working with peers and international organisations such as the Financial Stability Board, NGFS and the Basel Committee. We believe that the actions outlined above would equip investors to enhance system-wide resilience by enabling more effective market discipline.

We would welcome the opportunity to meet with you and your colleagues to discuss these matters in more detail. We are also copying this letter to the Financial Reporting Council, Financial Stability Board and NGFS given relevance to their mandates.

Yours sincerely,

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Chief Executive Officer, DPAM

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[3] We note multiple concerns, including inadequate data and controls, that bank auditors raised with the PRA as part of its thematic review on climate accounting in 2022 (https://www.bankofengland.co.uk/prudential-regulation/letter/2022/october/thematic-feedback-2021-2022-written-auditor-reporting).

[4] Investors have made clear their expectations for companies to provide climate-related financial disclosures in general (https://sarasinandpartners.com/row/wp-content/uploads/sites/6/2021/06/Investor-Expectations-for-Paris-aligned-Accounts.pdf), and specifically at banks in the investor-led Net Zero Banking Standard (https://www.iigcc.org/banks-engagement).

[5] https://www.bankofengland.co.uk/prudential-regulation/publication/2023/report-on-climate-related-risks-and-the-regulatory-capital-frameworks

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