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Climate risk:

Is the financial services industry prepared?

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Foreword

The 2010s was the hottest decade since records began in 1880.

It's a trend which shows little sign of abating over the next ten years, with NASA calculating that 2020 was tied with 2016 as the warmest year ever recorded. In fact, the last seven years have also been the seven hottest in terms of global average temperatures.

Climate change, fuelled by excessive greenhouse gas emissions, is contributing to a range of worrying phenomena, from rising sea levels and melting polar ice caps to heatwaves, natural disasters and species extinction.

The consensus among experts is clear: the time to act is now.

In this report, we'll examine the risks (and opportunities) associated with climate change, as well as the impact they are already having on hiring practices within the financial services industry.

We hope this report provides useful insight into this evolving area of risk management and welcome your feedback on how we can better support your climate risk recruitment needs.

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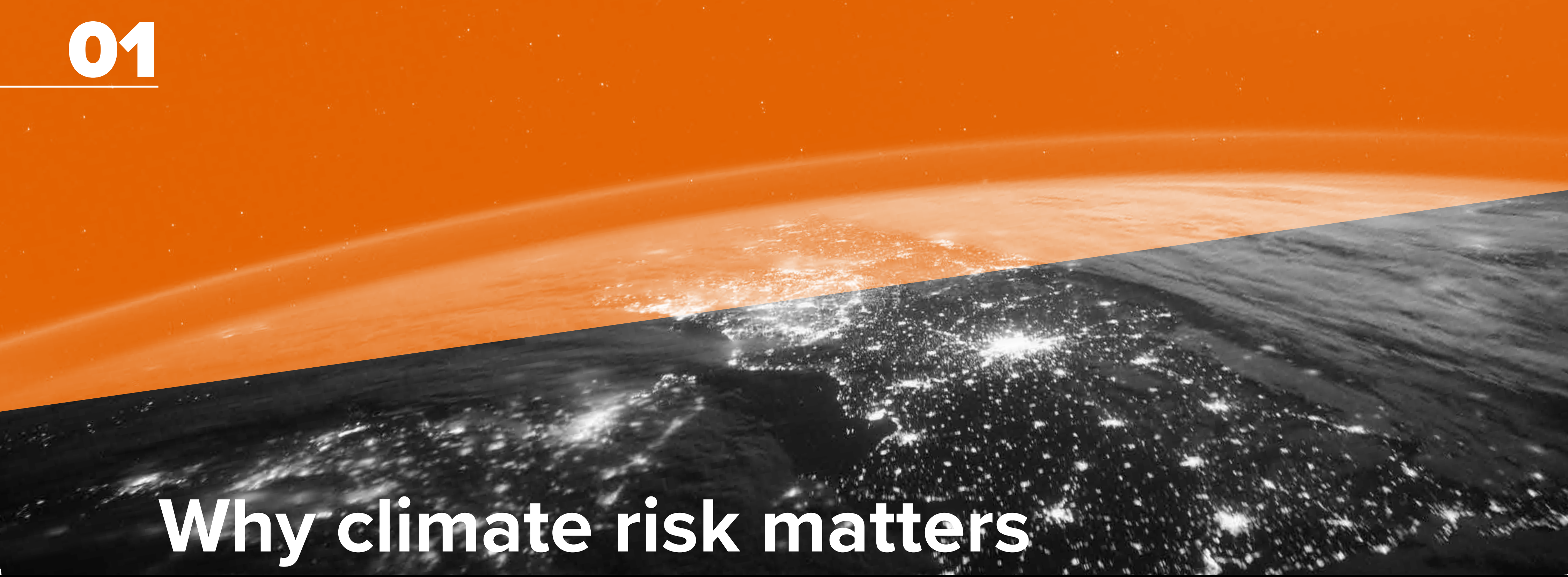

01

Why climate risk matters

Tackling climate-related risks has become a top priority for governments worldwide, as countries strive to meet ambitious national and international targets aimed at reversing current environmental trends.

Businesses have an important part to play in meeting these objectives, and the financial services sector is no exception.

Climate risk poses a significant threat to the stability of the financial system, and companies are facing growing pressure from regulators, customers and investors to calculate and manage these risks effectively.

There also significant opportunities for financial services firms that are proactive about climate risk and can help economies transition to low-carbon alternatives.

Societal pressures

People care about climate change. When asked if national governments should be doing more to protect the environment, 91% of respondents to a YouGov poll agreed and nearly half (48%) ‘very strongly’ agreed.

Concerns about the environment also appear to be growing. A December 2020 Ipsos Mori survey revealed 60% of Britons are now more worried about climate change than they were a year before, with 18% much more worried.

Customer expectations on the rise

>71%

UK banking customers are more likely to choose a bank with a positive social and environmental reputation.

>49%

Brits believe private companies should take responsibility first and foremost to address climate change.

>61%

61% of people wish their current provider performed better on these issues.

And it's not just the general public and customers who care; investors are also keen for companies to improve their green credentials. Recent BlackRock research showed climate-related risks are the top portfolio concern for 88% of asset managers, wealth managers and funds.

There are also indications that investors will become more vocal on environmental issues at annual general meetings (AGM).

For the first time, the Investment Association – the UK's asset management trade body – has announced it will issue 'amber tops' to companies in high-risk sectors that fail to report under recommendations set by the Task Force on Climate-related Financial Disclosures (TCFD).

Amber tops highlight significant issues that investors are encouraged to consider ahead of key AGM votes. As a result, shareholders may decide to vote against board recommendations if companies are failing to fulfil climate change responsibilities.

The Pensions Regulator also announced that it was considering taking enforcement action against pension schemes that fail to make mandatory climate risk disclosures under the Pensions Scheme Act 2021, which received Royal Assent earlier this year.

Regulatory drivers: Breaking the tragedy of the horizon

In September 2015, then-Governor of the Bank of England (BoE) Mark Carney described climate change as ‘the tragedy of the horizon’ in a speech to the Lloyd’s of London insurance market.

“*We don’t need an army of actuaries to tell us that the catastrophic impacts of climate change will be felt beyond the traditional horizons of most actors – imposing a cost on future generations that the current generation has no direct incentive to fix,*” he stated.

Subsequently, 2015 turned out to be a pivotal year for international progress on climate change. That year’s United Nations Climate Change Conference in France saw 196 state parties agree to adopt the Paris Agreement. The Financial Stability Board (FSB) also launched the TCFD at the event.

TCFD in focus

In 2017, the TCFD published a set of voluntary recommendations for businesses on how to disclose climate-related financial risks to investors, lenders and insurance underwriters. It has since become the gold standard for reporting such information.

According to the FSB, nearly 60% of the world’s largest public companies either support the recommendations or already report in line with them (or both).

Fast-forward to today and regulators worldwide are increasingly demanding increased awareness, preparedness and action from the financial services industry against climate risks.

What has this meant for UK firms? In 2019, the BoE’s Prudential Regulatory Authority (PRA) issued **Supervisory Statement (SS3/19)**, which outlined its expectations for how businesses should manage climate-related financial risks across four key areas:

1. **Governance arrangements**
2. **Risk management**
3. **Stress testing and scenario analysis**
4. **Disclosure**

The PRA expected businesses to have completed implementation plans for tackling these challenges by October 2019. Boards also had to allocate responsibility for climate-related financial risk management to an appropriate Senior Management Function (SMF) holder.

In a **letter addressed to CEOs** in July last year, the PRA announced all regulated firms must have fully embedded their climate risk frameworks by December 31st 2021.

Key dates for regulatory changes

End of 2021

All PRA-regulated firms must fully embed climate risk management frameworks.

2030

UK targets GHG reduction of 68% (compared to 1990 levels).

2050

EU and UK aim for net-zero emissions.

We spoke to Sarah Kemmitt, Consultant, Sustainable Finance at the United Nations Environment Programme Finance Initiative (UNEP FI) and former Manager, Climate Hub at the Bank of England, who gave us her thoughts on what the regulator expects from businesses by the deadline.

"*The key expectation is for climate risk to be embedded throughout banking and insurance institutions. This means recognising that climate risk is not something that can be tackled by one team but needs to be factored into the work of most teams throughout the institution, across all three lines of defence,*" she explained.

"*It also means that new practices need to have been implemented and, where feasible, to have gone through a few cycles.*"

With less than a year left until the end of 2021, where do companies stand?

02

How prepared are businesses?

Meeting the deadline

The clock may be ticking, but companies appear to be confident of their timelines for embedding climate risk frameworks.

A PwC survey, conducted in October 2020, found that 94% of PRA-regulated banks and building societies already believed they were on track to meet or beat the end-of-2021 deadline. If this confidence is well placed, it spells good news for the industry.

However, our conversations with industry experts suggest a more mixed picture. One Head of Risk at a multinational bank said fully implementing all requirements by December 31st to a high level of maturity would be a challenge, with a 'spectrum of preparedness' likely to emerge.

"*A phrase I'm hearing increasingly when regulatory preparedness is discussed is 'don't let perfect be the enemy of good'*," the senior decision-maker added.

Ms Kemmitt said climate risk is a rapidly evolving area that will require businesses to continue maturing their approaches over the coming years.

"*I think it's fair to say that banks and insurers will not have reached an end point by the end of this year. Many of them will have completed pilots and have started rolling out new policies and processes, but there will be a lot further to go in terms of embedding these in 2022*," she said.

And with the SS3/19 deadline fast approaching, more businesses will recognise the immediate requirement for key skillsets and subject matter expertise to implement and evolve their climate risk frameworks.

What roles are in demand?

The climate risk recruitment market is still developing, but momentum is building, particularly among big banks and other larger providers.

Some of the key roles commonly being advertised include:

- Climate Risk Manager
- Nature and Climate Risk Analyst
- Climate Change Risk SME
- Enterprise Risk Manager – Climate Risk
- Physical Risk Expert – Climate Change Impact
- Climate Risk Management Officer

Risks and opportunities

There are three generally accepted ways in which climate change can have a significant impact on a business's financial stability:

- **Physical risk:** the risks associated with adverse climate-related disasters, such as floods, droughts and bushfires. This also encompasses the cost of damage and lost productivity because of these events.
- **Transitional risk:** the risks relating to the policy-driven changes needed to move towards a low-carbon economy, including any write-offs for carbon-intensive technologies, products and processes that become obsolete.
- **Liability risk:** companies can face liability claims from stakeholders if they fail to disclose climate risks or don't do enough to adapt their operations to mitigate these risks. Businesses may also be liable for their GHG emissions.

Poor management of these risks could lead to significant financial and reputational damage. The global financial services sector faces losses estimated at up to $1 trillion from the introduction of a carbon tax alone.

Reputational damage is more difficult to calculate, but no less important to consider. For example, three-fifths (61%) of customers would leave their bank if they found out it was linked to social or environmental harm.

Climate risk and risk functions

All risk disciplines are affected by climate risk. Here are examples of how climate-related factors **can affect different risk areas**:

- **Market risk**
  - Natural disasters and/or climate policy changes leading to the re-pricing of various financial instruments, including equities
- **Credit risk**
  - Potential increases in defaults by businesses and households due to extreme weather events
  - Climate events causing collateral depreciation
- **Liquidity risk**
  - Climate-related risks adversely affecting refinancing opportunities
  - Greater liquidity needed to cope with climate risks
- **Operational risk**
  - Supply chain disruptions and facility closures as a result of physical risks
  - Broader business resilience problems and the associated effect on brand reputation
- **Reputational risk**
  - Environmentally conscious customers taking their business elsewhere if firms are perceived as not doing enough
  - Company stock prices falling due to loss of brand value

Pressure is also building from within. Over a third (35%) of UK businesses claim staff have left roles because they are dissatisfied with their employer's climate stance.

This could have serious repercussions for recruitment in the future, with 12% of organisations already struggling to hire young people in the UK because candidates have a strong desire to work for employers with better climate credentials.

It's not all gloomy news, however. There is a growing body of research showing there are many lucrative opportunities for businesses that adopt proactive climate change measures and behaviours. These include cost savings and new revenue opportunities for firms, as well as profitable long-term outcomes for shareholders.

"*The financial industry can have a significant impact on accelerating the transition to a green economy by proactively steering capital towards the businesses and technologies that will drive it,*" said James Davis, a Partner at Oliver Wyman.

And despite various challenges, there seems to be a healthy appetite for robust climate change regulations; 76% of respondents to PwC's preparedness survey welcomed the establishment of a global regulatory regime for climate risk management and 94% thought the TCFD disclosure recommendations should be mandatory.

Key trends in ESG investments

Green lending

Green lending grew nearly 250% YoY in 2019

Sustainable

Sustainable bonds to become $650bn market this year

Investors

Investors to double allocations to ESG assets by 2025

€1.2 trillion

New low-carbon revenue opportunities identified in 2019 alone

Which businesses will be most affected?

Almost all banking and financial services firms are going to be exposed to the physical, transitional and liability risks of climate change.

This is across both their own internal operations and via the firms and customers they lend money to and trade with. For example, a UK-based retail banking or mortgage lending business could face significant physical risks across its home loan portfolio, while transition and reputational risks may be more problematic for big international banks that have large corporate portfolios.

But while differing business models and portfolio holdings will decide what specific risks are most prominent to individual firms, the consensus among industry experts is that all sectors need to adapt – and quickly.

Beyond financial services

While financial services are the primary focus of this report, it is worth noting that climate risk affects virtually all industries. The Intergovernmental Panel on Climate Change has listed **several key sectors** that will experience the biggest impact:

- **Energy**
- **Water services**
- **Transport**
- **Recreation and tourism**
- **Manufacturing**
- **Construction and housing**

From a regulatory perspective, Chancellor Rishi Sunak announced last year that TCFD-aligned disclosures will be fully mandatory across the UK economy by 2025, including listed commercial businesses and UK-registered large private companies.

That said, the insurance industry is often highlighted as facing potentially the biggest exposure to climate risk due to the rising frequency and severity of extreme weather events.

The sector suffered $83 billion (£60 billion) in global losses in 2020 because of man-made and natural disasters, according to Swiss Re Institute data. It was the fifth costliest year on record, with four of those five years **occurring since 2010**.

Smaller financial services businesses are also likely to shoulder more of a burden when tackling climate risk, both in terms of their potential exposure and regulatory pressure.

"*Climate risk approaches and methodologies are tending to be developed by larger firms, and these might not be so accessible or suitable for smaller firms which do not generally have the resources and expertise to dedicate to this risk driver*" said Ms Kemmitt.

"*However, smaller firms are not immune from climate risk, and in fact they might be more exposed if concentrated in a geography, product or sector that turns out to be vulnerable.*"

The PRA has attempted to address some of these concerns by confirming it will apply the proportionality principle to climate risk. Firms will therefore only be expected to respond in a way that is proportionate to their size and complexity.

03

Climate risk and recruitment

The top concern for risk professionals over the past 12 months has undoubtedly been Covid-19. And – if recent global surveys are to be believed – the ongoing fallout from the pandemic will remain the biggest priority for risk teams throughout 2021.

We are nevertheless seeing climate risk continue to rise up boardroom agendas. Covid-19 has arguably even refocused attention on climate risk, with the pandemic already being described as the first sustainability crisis of the 21st Century.

The virus has shown how quickly and profoundly business continuity can be unexpectedly disrupted, with many Chief Risk Officers recognising that climate change poses similar threats.

So, how are businesses approaching climate risk from a staffing perspective?

The current state of play

The lion's share of climate risk hiring is occurring at big banks and asset managers, which is understandable. These firms are highly visible to the regulator and have the necessary resources to recruit the talent they need. In addition, consultancies continue to actively hire, seeing climate risk as a key commercial growth area – a good barometer of future demand.

At the company level, research shows most firms do not yet have a dedicated climate risk team, instead preferring to deploy specialist staff within existing credit, market, operational and liquidity risk functions.

This is often a strategic choice, with companies recognising that climate risk affects all areas of risk management. Some firms are also too small to warrant separate teams, in which case climate risk responsibility typically falls upon the CEO or MD.

Even at large companies, climate-related activities are often initially undertaken by existing staff in addition to their usual responsibilities, occasionally with added support from short-term specialist contractors. Many employers are also hiring from within when setting up new climate risk teams.

However, businesses report that this often becomes unsustainable as roles and responsibilities increase, resulting in the need to recruit externally for permanent staff with climate risk skills and experience.

Fears for the future

80% of risk professionals are confident their climate risk strategy offers resilience over the next five years. Just 10% say the same beyond 15 years.

75% of businesses believe their company's management lack critical climate risk skills and experience.

83% of senior decision-makers feel climate risk will be a big factor in whether they keep their jobs or not over the next five years.

Getting the right team in place

Companies don't have long to fully embed their climate risk frameworks before the end of this year. Many also recognise that climate change preparedness extends beyond their immediate regulatory obligations.

How can businesses ensure they are well positioned from a staffing perspective to tackle climate risk for both upcoming UK regulations and the longer-term horizon?

A broad spectrum of skills is required

We believe there is no one-size-fits all approach to climate risk management. There will be elements of both quantitative and qualitative risk assessment, along with the need to develop, embed and run risk frameworks effectively.

Firms will therefore need a mix of skills to assess the financial, operational and reputational risks to their specific business from climate change over the short, medium and long term.

In many cases, this requires both generalists and specialists. Generalists offer a solid understanding of how financial institutions work, as well as key insights into the relevant regulation, resources, tools and initiatives that are available to support climate risk efforts. Specialists will likely be required for the more technical aspects of climate risk, such as scenario analysis and carbon accounting.

Leverage insights from inside and outside the industry

Credit risk analysts, particularly those with experience covering high-carbon industries such as transport, natural resources, power and energy, are a popular choice for businesses looking to strengthen their climate risk management.

These professionals are already having regular climate risk conversations with their clients – and have been for several years, so they are well placed to drive change in this area.

But it's important to remember that climate risk specialists exist across many industries. To build robust risk management frameworks, organisations should harness the skills of a range of experts, including scientists, economists and academics.

Utilise the expertise of interim staff

A fairly intensive period of change will be occurring in the short to medium term as companies continue to introduce new climate risk policies and integrate them across risk functions and the wider business.

At the moment, the climate risk recruitment market is not sufficiently mature to provide a population of candidates who are both experts in climate risk and familiar with banking and financial services products and regulatory frameworks.

Contractors and other interim specialists can provide essential support in the meantime, helping businesses deliver the necessary changes to achieve regulatory compliance and climate risk futureproofing.

Appoint your first CSO

An increasing number of firms are recruiting Heads of Sustainability or Chief Sustainability Officers (CSOs) for the first time. Currently, [80% of CSOs are recruited internally]; however, we expect external hiring to rise as sustainability-focused roles become more common.

When asked by Deloitte what skills were most desirable in a CSO, financial services firms chose 'strategy', 'influencing' and 'risk analysis and management' as their top three. Technical skills, such as 'data and quantification', 'climate science knowledge' and 'compliance' were considered less important, although these skills were more highly valued among insurers and asset managers than banks.

These results are perhaps unsurprising, given that the CSO's mandate is typically focused on the bigger picture for sustainability rather than granular technical details.

Do we need a CSO?

Deloitte recently highlighted three tipping points that businesses often reach before making their first CSO hire:

1. External change outpaces internal change: CSOs act as 'sense makers' when regulations, international standards and national legislation evolve too quickly for a company's existing systems to handle.
2. Stakeholder expectations exceed reality: Investors, customers, staff and a multitude of other stakeholders have begun to demand sustainable approaches and attitudes that are not yet embedded within the business.
3. Climate risk becomes a strategic priority: ESG risks prompt widescale market shifts that become too big to ignore for the firm. CSOs are often then needed to translate sustainability strategy into practice.

According to Deloitte, one-third of CSOs report directly to their CEO, a set-up they claimed is essential to making the role effective.

Upskill and educate existing staff

We are already beginning to see roles that require both an understanding of climate risk and experience within the financial services sector. This combination of skills is rare in such a developing market.

Upskilling and educating existing staff on climate change will therefore be beneficial to fill skills gaps, both within the risk function specifically and across the organisation more generally.

One way to upskill the workforce is through official climate risk accreditations and courses. The new [Sustainability and Climate Risk (SCR®) Certificate] offered by the Global Association of Risk Professionals (GARP) is a qualification that is attracting the attention of industry professionals. GARP's [Climate Risk Resource Center] is also a valued resource for sustainability and climate risk information.

The CFA Institute also runs a Certificate in ESG Investing that is useful for buy-side professionals.

Consider all three lines of defence

Over time, climate risk will become better embedded across the three lines of defence model, supplemented by experts who can provide specialist input and oversight. But we're not quite there yet.

For example, audit professionals have suggested there is a clear disconnect between the importance organisations place on climate risk and the amount of time and resources that audit teams have been allowed to allocate to such tasks.

The Chartered Institute of Internal Auditors revealed that 52% of auditors had done limited or no work related to climate change as of November 2020.

Strengthen your scenario analysis

Climate scenario risk analysis and stress testing will form a vital component of the overall assessment of climate risk. This function is currently being carried out by risk stress testing analysts alongside their other responsibilities in capital, liquidity, credit and market risk.

However, of the PRA's four regulatory pillars, scenario analysis has emerged as one of the areas giving businesses the most problems as the end-of-year deadline approaches. These difficulties have been acknowledged not only by the regulator but also the industry experts that we spoke to.

53% of firms have conducted scenario analysis, with all respondents citing a lack of suitable data as the main obstacle.

As a result, we expect risk professionals with scenario analysis skills to become increasingly in demand as businesses further embed their climate risk processes this year and beyond.

Hear from Andrew Newton, Executive Director, Strategic Risk at SMBC to learn his views on climate risk, including the risks and opportunities facing the industry. Read the full article.

Working with a specialist recruiter

When looking to build a team that can support and negate any potential issues posed by climate risk, engaging a specialist recruiter will save you time and money. Barclay Simpson has one of the most established risk recruitment teams with a proven track record across all functions of risk management. To ensure you get the bespoke risk management professionals you need to protect the growth and sustainability of your organisation, our consultants are knowledgeable across all areas of risk and can suggest tailored solutions to suit you.

Get in touch to learn how working with Barclay Simpson can help you build the risk management team you need to secure your company's future.

Conclusion

The financial services industry is facing unprecedented pressure from regulators, customers, staff and other stakeholders to play a more active role in tackling climate change.

Many businesses are already rising to the challenge, with climate risk firmly at the top of the agenda as the PRA's SS3/19 deadline looms for embedding risk management frameworks.

However, firms must continue to build strong, versatile risk management teams if they want to avoid climate risks and take advantage of the opportunities available as countries transition into low-carbon economies.

The climate risk field is relatively young but maturing quickly, so it is important that employers work with a partner who understands the market and can source the right skills and experience to futureproof their business.

About Barclay Simpson

Risk is deeply embedded in financial services CEOs' agendas and with the proliferation of the Chief Risk Officer and Chief Sustainability Officer roles, demand for risk professionals has risen steeply over the past decade. The high growth and development of businesses combined with increased scrutiny from regulators has meant that recruiting for risk is an increasing priority for many, even whilst the risk talent market remains challenging to navigate.

Finding a recruiting partner to help you find the right risk professionals to suit your company, your culture and your ethos will ensure you have a lasting risk team capable of adapting to the ever-evolving pressures of risk.

Arrange a consultation today to see how Barclay Simpson can support you as you build a risk management team that's future proof.

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