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LEADERSHIP AND OPERATING MODEL DEVELOPMENT IN CLIMATE RISK

Introduction

For many firms, Climate Change has not been the priority during 2020. The primary effort this year has been on combatting the impact of Covid19; in responding to the operational, social, economic, and logistical challenge resulting from the disease. However, when we look back 2020 will be a significant year for Climate Risk, as Climate Change remains the biggest challenge of our time and this ever-growing awareness is leading to action by Investors, Regulators and finally, Governments.

Regulators and Investors are starting to apply increased pressure to firms as consensus increases that climate change poses significant risks to the stability of the financial system. Climate Risks for Banks, Insurance firms and Investment Funds are those risks which decrease the value of financial assets resulting from a reduction in economic activity or damage to property directly caused by climate change, or the transition risk associated with moving to a low carbon economy.

Action is being taken by policymakers. Following the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) and action by the Prudential Regulation Authority, the UK Government issued their Ten Point Plan in November for a Green Industrial Revolution, with at its heart the plan to mobilise £12bill of government investment. More is needed.

Financial Services firms are responding, but at different rates. The GARP Risk Institute undertook a survey of banks, insurers, and asset managers to determine progress this year. This showed that 80% of firms had board level oversight of climate risk, strategy, and risk management but other areas of climate risk, such as scenario analysis are still immature.

Previously firms treated Climate Risk as a reputational risk which sat within their ESG function, whereas firms are now structuring climate risk as a financial risk and embedding it into their risk management structures.

The purpose of this paper is to present the leadership challenge of Climate Risk and outline the progress and evolutionary development of operating models as they adapt to the refocussing of climate risk within Financial Services firms. It is also to look at the impact these developments are having on organisational design and structures and the likely future path for firms.

Responsibility and Governance for Climate and Sustainability

Within firms, responsibility for Climate and Sustainability is fragmented and follows the existing corporate structures. There are three main contributors to the Climate and Sustainability agenda within firms, these are:

- Environmental, Social and Corporate Governance (ESG). The ESG function has typically reported into the Board through a Director of Corporate Action. Historically

ESG has had responsibility for Climate Risk.

- Sustainable Finance product development are led out of each business line. For instance, in Financial Services, a Head of Sustainable Mortgage Products will report to the Board through the CEO for Retail Banking. The same would apply for Commercial Banking, Investment Banking, Asset Management, or Insurance products.

- Climate Risk. With the articulation of Climate Risk as a Financial Risk for firms, in most cases the Chief Risk Officer will be responsible for Climate Risk, although occasionally the Chief Financial Officer.

This fragmentation was neatly articulated by one senior banking executive who commented that the process has begun to rearchitect these cottage industries, to create a deeper ecosystem of knowledge and talent within the next 12 months.

Ultimately all these functions report to the Board and to the Chief Executive Officer. The Board carries ultimate responsibility for oversight of all climate and sustainable finance strategy, products, and risk management. As regulatory oversight increases so must the Board and Senior Management oversight.

The Prudential Regulation Authority released SS3/19 last year with an outline of the regulator's expectations for governance, risk management, scenario analysis and disclosure. This was followed by the Dear CEO letter which set the deadline of the end of 2021 for firms to embed their approach to managing Climate Risk.

The Board must have clarity and understanding of how the strategy for Climate Risk aligns with the firms broader Risk Strategy and Risk Appetite. Responsibility for Climate Risk falls under the Senior Manager and Certification Regime (SM&CR), which means that accountability for Climate Risk rests with the Board and Senior Managers with associated legal and financial penalties for non-compliance.

Much of this responsibility will fall to the Chairs of Risk, Audit and Remuneration Committees. RemCo should pay close attention to the remuneration structures in place to ensure incentives are linked to culture and climate objectives.

A fit for purpose Climate Risk Framework

As outlined in the introduction, Climate Risk can be split into two distinct types:

- Physical risks – caused by financial loss resulting from physical events such as flood or similar weather impact, and
- Transition risks – financial detriment resulting from transition to a low carbon

economy such as the transition from petrol/diesel to Electric Vehicles.

Firms are at various stages in building their Risk Management Frameworks for Climate Risks, with the critical components being:

1. Climate Risk Identification
2. Risk Measurement, Stress Testing and Scenario Analysis
3. Risk Appetite and Evaluation
4. Risk Monitoring
5. Risk Management and Mitigation
6. Reporting, MI, and Disclosure

The PRA would like firms to use Scenario Analysis to test resilience against both short term transitional and longer-term physical risks, utilising Internal Capital Adequacy Assessment Process (ICAAP) for Banks or the Own Risk and Solvency Assessment (ORSA) for Insurers. Whilst most firms are in the process of establishing the operating models, structures and programmes for Climate Risk, Scenario Analysis is lagging. Firms should also be prescient of the opportunity arising out of effective scenario analysis, which when undertaken in a robust manner will help prioritise green investment opportunities for firms.

Mandatory Reporting is coming

Although firms must report material risks under Pillar III, reporting against Sustainability or Climate Risk targets is not yet mandatory. Currently the PRA encourages firms to report under the Task Force on Climate-related Financial Disclosures (TCFD). Despite this, TCFD has been adopted by over 1600 companies and organisations in nearly 80 countries, representing more than $16 trillion in market capitalisation, including financial services firms with $155 trillion of assets under management.

Furthermore, over 9600 firms disclosed their Climate related data to CDP this year, causing Paul Simpson, CEO of CDP to comment, "We have seen very strong momentum this year in corporate disclosure despite the extremely challenging year we have all had with COVID-19," he said. "However, as we look ahead to 2030, I am acutely aware of the urgency with which we need to act, and unfortunately, the climate and ecological emergency remains."

Mandatory reporting is coming, with the UK, Canada, France, Japan, and New Zealand all making commitments to introduce mandatory reporting along TCFD guidelines. In November, the UK led with the announcement by Chancellor Rishi Sunak that the UK would be the first to introduce mandatory reporting for listed companies in line with the recommendations of TCFD.

Evolving Operating Model

To meet this increasing emphasis on Climate Change driven by Regulators, Investors and NGO's (such as TCFD), the operating model and organisational design for Climate Risk is evolving rapidly within all firms.

Firms are currently adopting a hub and spoke operating model which should be consistent with the three lines of defence required by the regulator; the hub undertaking the coordination of second line of defence activities and including a small central team or centre of excellence at the firms group HQ. This team has oversight over the firm's policies and procedures relating to Climate Risk, empowering a de-centralised model where the individual business units or geographies have delegated authority. For this to work efficiently, respondents highlighted the need for excellent governance, board level oversight and incentivised leadership.

Firms also highlighted the need for clear delineation of responsibility between Climate Risk and Environmental, Social and Corporate Governance (ESG). Climate Risk should report up to the Chief Risk Officer (CRO), who is responsible for second line risk oversight relating to the financial impact of climate change and is a check on the first line Climate opportunity and innovation which is led out of the business.

Climate Risk culture will be a critical instigator of success. Culture should be reflective of the Board's approach to Risk culture, so it is critical to appoint a Senior Manager to lead Climate Risk who embodies the Climate Risk ethics, values, and culture of the firm and who carries the credibility and influence to shape the firm's thinking. Typically, they will be an energetic thought leader with the political experience to navigate and agitate at the most senior level of the organisation. Firms should consider appointing a Senior Manager with accountability for Climate Risk as a direct report to a Board member, either the CRO or CFO being most logical. This serves two purposes, communicating the importance of Climate Risk internally to the organisation and externally to customers, regulators or third parties.

This is a departure from traditional thinking, where the reporting line for Climate Risk was into ESG, or more recently where Climate Risk reported into the Head of Enterprise Risk or the Risk COO (typically two levels below Board).

It will be critically important for the Head of Climate Risk to ensure they have the right talent in place and where they do not, hiring or training key personal, whilst educating the Board and wider organisation on Climate Risk. This role should have executive accountability for the strategy and risk appetite for the firm as well as establishing the risk management framework for Climate Risk and a clear structure for the three lines of defence as required by the regulator.

Organisational Design

Depending on the maturity of Climate Risk development within firms, a typical structure beneath the Group Head of Climate Risk will include a small specialist central team, between four and 12 people. Most teams are currently very small, consisting of only four to five people. In only a few instances firms have a larger central team of eight to 12.

The established structure for most firms typically includes a small team of Executive Directors reporting into the Group Head of Climate Risk. For most firms, the structure of the centralised Climate Risk function will reflect the maturity of the Climate Risk framework and will include experts with experience in sustainability, risk framework and policy development, credit risk and programme management. For firms more advanced in scenario analysis, this may also include modelling, stress testing and scenario analysis capability.

Therefore, competencies typically mirror the development of the climate risk framework and will include the following expertise:

1. Risk Framework to develop policies and procedures for Climate Risk
2. Credit Risk expertise to support evaluation and the development of Risk Appetite
3. Sustainability expertise
4. Programme Management capability
5. Disclosure and reporting expertise
6. Modelling, Stress Testing and Scenario Analysis (embryonic for many firms)

For most firms, the implementation of Climate Risk will rest within the business with oversight and accountability from business line, regional or country CRO's. Many firms are currently in the process of building out these structures, in some cases firms have appointed Heads of Climate Risk for regions such as Americas, APAC, Europe. However, firms have been slower to appoint Heads of Climate Risk for each business line although we are starting to see these roles emerge for Heads of Climate Risk for Retail Banking, Commercial Banking, Investment Management.

The Group Climate Risk function is supported by many Risk professionals within the business who will include accountability for Climate Risk as a proportion of their role. For instance, the Head of Enterprise Risk for Retail Banking will have 20% of their time dedicated to Climate Risk. The number of people with this responsibility will vary depending on the size of firm, but typically range from 50-150 people for large global financial services firms.

The War for Climate Risk Talent

Firms must focus on building capability with the multi-functional and multi-dimensional expertise necessary to be impactful within the complex arena of Climate Risk. Executives must bring strong technical expertise with outstanding leadership and communication skills to influence stakeholders. Candidates should also have a transformational mindset with an innovative approach to problem solving, as many of these challenges are being tackled for the first time.

The most effective talent will be those who can balance the competing demands of policy idealism, political activism, commercial pragmatism, and corporate realism. One senior executive commented that within the cradle of Climate Risk development, an outstanding operator must have the ability to hug stakeholders with one arm, whilst arm-wrestling them with the other. Being a tree hugger and a good corporate citizen should not be mutually exclusive.

Recruiting multi-dimensional talent into these specialist markets will require firms to examine

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untapped pockets of talent both internally and externally.

Future Path

With the looming deadline at the end of 2021, firms need to move quickly to establish the structures and functions necessary to meet the regulatory requirements. They also need to rapidly identify and deploy resources with the multi-dimensional expertise to contribute to firm's Climate objectives.

These teams will grow throughout 2021, with increasing focus on scenario analysis. This will absorb huge amount of time, either fully dedicated as in the case of central teams or borrowed proportionately to the criticality of the business unit or function. Teams are likely to grow significantly and will reach a peak as we reach the regulatory deadline. However, as firms establish a robust framework for managing climate risks and embed these decisioning making processes and systems into the firm, these teams will reduce.

Firms should use a combination of consultancy expertise, interim management subject matter and programme expertise, combined with permanent resources to mobilise with flexibility.

To discuss any aspects on this paper, please contact Bateman Collins International.

The content provided in this paper is intended solely for general information purposes.

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