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Bank of England Issues Updated Assessment of Climate-Related Risks and Regulatory Capital Requirements for Financial Institutions

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The Bank of England released a report titled **Climate-Related Risks and the Regulatory Capital Framework** (Report) on March 13, 2023. The Report expands on the Bank's 2021 **Climate Change Adaptation Report** (CCAR), in which it articulated initial views on existing regulatory capital frameworks for banks and insurers in relation to climate change. The CCAR concluded that the frameworks already in place, such as then-existing capital models and credit ratings, captured climate-related risks "to some extent." The Bank's updated assessment as set forth in the Report adopts a more cautious tone, concluding that the risk assessment "may be incomplete due to the difficulties in estimating climate risks (capability gaps) and there may be challenges in capturing risks in the existing capital regimes (regime gaps)."

According to the Report, these existing "capability and regime gaps" create uncertainty around whether banks and insurers are capitalized sufficiently for risks of climate-related losses in the future. The Bank observed that this uncertainty represents a "risk appetite challenge" for regulators, who "need to form judgements on whether quantified and unquantified risks are within acceptable risk levels." The Bank also stated that effective risk-management controls can reduce "the quantum of capital required in the future for resilience" to climate change losses, but "the absence of controls might suggest a greater quantum of capital will be required." In the short term, "the Bank is focused on ensuring firms make progress to address 'capability gaps' to improve their identification, measurement and management of climate risks." The Bank will undertake further analysis to explore whether changes to regulatory capital frameworks will be required. In particular the Bank will: develop its capabilities and forward-looking tools to determine the resilience of the financial system to climate risks; support initiatives to enhance climate disclosures; promote high quality and consistent accounting for climate risks; and address material regime gaps in capital frameworks.

Taking The Temperature: The Bank is focused on ensuring that climate change risks and the opportunities that may arise from a transition to a net-zero economy are being

identified and managed across the financial sector. Instead of proposing any specific policy changes, the Report paves the way for further work by the Bank to explore and determine what changes (if any) need to be made to existing regulatory capital frameworks. The Report recognized that the "unique characteristics of climate risks mean that their capture by capital frameworks requires a more forward-looking approach than used for many other risks. Scenario analysis and stress testing will play a key role in this." The emphasis on scenario analysis in conjunction with overall risk assessment mirrors the importance placed on such exercises by other financial regulators, including the Federal Reserve and the European Banking Authority. Financial institutions should also note the Bank's conclusion that increased capital requirements may be needed to address any absence of controls: because the Bank, like the European Parliament and national bank regulators elsewhere, have highlighted the use of the Basel III regime to address material climate risks, the Bank or the Prudential Regulation Authority very well could take action to address any significant capital or supervisory weaknesses.