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SOUTH AFRICAN RESERVE BANK
Prudential Authority

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To: All banks, branches of foreign institutions, controlling companies, eligible institutions and auditors of banks or controlling companies

Proposed Guidance Note issued in terms of section 6(5) of the Banks Act 94 of 1990

Proposed Guidance on climate-related risk practices for banks

Executive summary

This Guidance Note provides guidance to banks, branches of foreign institutions and controlling companies (hereinafter collectively referred to as 'banks') on integrating climate-related risks into their governance and risk management frameworks, including guidance on banks' internal capital adequacy assessment process (ICAAPs).

1. Introduction

1.1 Climate change may result in physical and transition risks that could affect the safety and soundness of individual banks and have broader financial stability implications for the banking system. To this effect, it is imperative that banks take active steps to address climate-related financial risks within the banking sector.

1.2 The Prudential Authority (PA) has developed this guidance notice to contribute to the strengthening of the regulation and supervision of climate-related risk management within banks with the purpose of enhancing financial soundness and stability.

2. Governance

2.1 General

2.1.1 Climate change may trigger physical and transition risks that could pose a threat to the safety and soundness of banks and have broader financial stability implications to the banking system globally. Individual banks could be potentially affected by climate-related risks irrespective of the size, business model and complexity of the bank. The Board of Directors and senior management should develop processes and policies for assessing potential impacts of climate-related risks on their business model, overall strategy and environment in which they conduct business. Equally, the Board of Directors and senior management should assign clear roles and responsibilities and ensure effective oversight of climate-related risks.

2.2 Appropriate allocation of oversight and management responsibilities

2.2.1 The Board of Directors and senior management should clearly identify and assign responsibilities throughout the bank's organisational structure for managing climate-related risks.

2.2.2 The Board of Directors may delegate the management of climate-related risks and has the responsibility to monitor the exercise of the delegated functions and activities.

2.2.3 The delegation arrangements should include a clear assignment of the delegated responsibilities, and mechanisms for monitoring the exercise of the delegated authority.

2.3 Roles and responsibilities of the Board of Directors and senior management

2.3.1 The Board of Directors and senior management are responsible for the effective and successful implementation of managing climate-related risks. In fulfilling its responsibilities, the Board must consider the following principles:

2.3.1.1 The Board and senior management should develop comprehensive policies and processes that will assist in identifying climate-related risk drivers and assessing the potential impacts thereof on the bank.

2.3.1.2 The Board and senior management should identify climate-related risks that are material to its business model, and incorporate the identified risks into its risk profile, risk management and overall business strategy.

2.3.1.3 The Board and senior management should effectively assign roles and responsibilities to various business units or committees developed to manage climate-related risks and exercise oversight over the management of the risks.

2.3.1.4 The Board and senior management should ensure they have an equal and adequate understanding of climate-related risks.

2.4 Policies

2.4.1 Banks should adopt and oversee implementation of robust governance policies that will identify, monitor, report and mitigate climate-related risks impacting the bank.

2.4.2 The bank's policies and procedures should:

2.4.2.1 Make provisions for the identification, monitoring, and reporting of climate-related risks;

2.4.2.2 Be commensurate with the risk profile of the bank; and

2.4.2.3 Be regularly reviewed to ensure that the framework is developed in line with the evolving nature of climate-related risks.

2.5 Strategy

2.5.1 Banks should manage climate-related risks within their overall business strategy and risk appetite, and the Board should be able to evidence their ongoing oversight of these risks.

2.5.2 Climate-related risks should be incorporated and assessed as part of the bank's annual financial planning.

2.5.3 Banks may adopt an internal risk committee that is responsible for addressing climate-related risks and identifying the changing risk landscape.

3. Risk Management

3.1 General overview

3.1.1 Banks are expected to integrate climate-related risks into their risk management frameworks. The management of climate-related risk must be proportionate to the nature, size, and the complexity of the institution. In addition, banks are expected to treat climate risk as a financial risk rather than merely a reputational risk event.

3.1.2 Banks should be able to demonstrate that climate-related risk has been considered as part of strategic planning and business practices.

3.1.3 Banks should consider climate-related risk in their strategy setting and credit risk management practices.

3.2 Risk management framework

3.2.1 Banks should identify, measure, monitor and report on exposures to climate-related risk. Banks should be able ensure that this is embedded in the Enterprise Risk Management framework.

3.2.2 The bank's documented risk appetite and risk management policies should include climate-related risks.

3.3 Risk mitigation and monitoring

3.3.1 Banks should identify, measure, and monitor climate-related risks.

3.3.2 Scenario analysis can be used as a tool to measure potential impacts of climate-related risks.

3.4 Risk management function

3.4.1 The risk management function is expected to provide the Board of Directors and its subcommittees with reports on exposures to climate-related risks to enable the Board to discuss, challenge and make decisions relating to the bank's management of climate-related risks.

3.4.2 The risk management function should ensure that climate-related risks are integrated into the current risk management processes and climate-related risk considerations are included in the relevant risk management policies and governance processes.

3.4.3 The risk management function is expected to develop risk metrics to be used in monitoring progress against risk appetite.

3.5 Internal audit function

3.5.1 The risk management process that applies to climate-related risks should be reviewed by the internal audit function to ensure the adequacy and effectiveness of the process. Where climate-related risk is material, the internal audit function should assess the impact of the risk on the bank's resilience and consider the appropriateness of mitigation measures.

3.6 Compliance function

3.6.1 The compliance function should ensure that climate-related risks are identified and accounted for in the compliance risk management framework.

3.6.2 Climate-related risks from the perspective of the compliance function relate in the main to legal risk (liability risk)[1] and legal change risk (disclosure risk related to the failure to disclose climate-related risk exposures).

3.6.3 The compliance function should ensure that internal policies and controls are compliant with relevant regulatory and supervisory frameworks and as these relate to climate-related risks. International frameworks should be considered where the bank operates within international jurisdictions.

3.6.4 The compliance function should on a continual basis assess climate-related legal liability risks.

3.6.5 The Board of Directors should remain cognisant of potential direct legal action against the bank for failing to manage climate-related risks.

3.6.6 The compliance function should ensure that climate-related litigation drivers are well understood within the bank and adequately captured in the risk management framework.

3.7 Control function

3.7.1 The specialist nature of climate-related risk may require a unique skill set from the Control Functions. These skills may be procured through capacity building or through the insourcing of specialist skills adept at addressing the nuances of climate-related risks.

3.7.2 Banks should therefore adapt their internal policies and implement appropriate training programs to ensure that there is sufficient understanding of the impact of climate-related risk on the risk profiles of the bank. Control Functions to this end should ensure that persons performing such functions possess the necessary experience in understanding climate-related risk.

3.7.3 The bank may designate specific persons or a specific dedicated unit within the relevant control function to maintain primary responsibility for climate-related aspects and to ensure that climate-related risks remain in scope and integrated into all relevant parts of the bank’s business.

3.7.4 In determining capacity building initiatives, the bank should remain cognisant of principles of proportionality relative to the size, nature and complexity of the bank.

3.8 Outsourcing

3.8.1 Outsourcing material activities and functions is an inherent part of the activities of a bank. Banks should therefore ensure that there is continuity of the outsourced functions in the event of failure of an outsourcing service provider.

3.8.2 The bank should ensure that business continuity plans account for physical risks that may disrupt the operations of the outsourced service provider.

3.8.3 Business continuity plans should therefore reflect climate-related risks where such risks are deemed material.

3.8.4 Banks may consider utilising physical risk scenarios in assessing the climate related risk associated with outsourced service providers.

[1] The risk of climate-related claims as well as direct actions against banks, for failing to manage climate risks.

3.9 Transition plans

3.9.1 Transition plans, and the process of transition planning, are an important tool to manage climate-related risks and achieve commitments to climate targets.

3.9.2 There is an emerging consensus on the general concept of transition plans as an articulation of an institution's forward-looking approach to the transition to a low carbon economy.

3.9.3 As part of climate risk management, banks should consider undertaking transition planning and compiling transition plans in proportion to their size, business model and complexity. Transition planning should consider geopolitical considerations, government policy and the structural changes required in the real economy. International frameworks should be considered where applicable.

4. Internal Capital Adequacy Assessment Process (ICAAP)

4.1 General

4.1.1 Climate-related risks may have an impact on banking institutions regardless of their size, complexity, or business model. As a result of the exposure to climate-related risk, the regulatory capital framework places increased emphasis on risk management and banks are required to employ suitable process, procedures, and systems to ensure capital adequacy commensurate with their risk profile to safeguard against these risks. It is therefore imperative for banks to consider climate related risks into the bank's ICAAP to ensure adequate coverage to exposures.

4.1.2 Banks should have risk analysis capabilities by identifying relevant climate-related risk drivers that may materially impair their financial condition.

4.1.3 Adequate key risk indicators and metrics should be developed to quantify exposures to climate related risks.

4.1.4 Banks should assess the links between climate-related risks and traditional financial risk types such as credit and liquidity risks.

4.2 Stress testing and scenario analysis

4.2.1 Scenario analysis is an important tool in helping banks understand the potential impact of climate-related risks and how it impacts their business. Climate risk scenario analysis will assist banks in determining and quantifying the potential exposure to physical risks and transitional risk.

4.2.2 Whilst scenario analysis in respect of climate-related risk is evolving, banks are expected to use scenario analysis to understand the impact of climate risk on their solvency and liquidity.

4.2.3 Banks should:

4.2.3.1 Have written policies in place governing the scenario analysis and stress testing methodologies;

4.2.3.2 Consider a forward-looking view of climate-related risks through scenario analysis and stress testing as part of the ICAAP assessment process;

4.2.3.3 Include results of forward-looking stress tests for a minimum of 3 years and ideally 5 years when evaluating the bank's capital adequacy. These should be based on plausible adverse circumstances;

4.2.3.4 Perform comprehensive and rigorous stress tests to identify possible events or market changes that may have serious adverse effects or significant impact on the bank’s capital and operations; and

4.2.3.5 Incorporate quantitative and qualitative techniques in stress testing to assess the impact on the banks’ exposures to specific events.

4.2.4 Stress-testing should be actionable, with analysis results that can affect decision-making at the appropriate management and strategic levels.

4.3 Reporting

4.3.1 The ICAAP process should cover the following:

4.3.1.1 The methodologies used to identify, assess/measure, monitor and report climate-related risks and in determining the related internal capital. These should be reviewed continually.

4.3.1.2 The treatment of correlation among risks and the determination of total internal capital.

4.3.1.3 The type and nature of the scenario analysis and stress tests adopted to assess climate-related risks; and

4.3.1.4 Contingency plans to deal with divergence and unexpected events.

5. Invitation for comments

5.1 Banks and other interested persons are hereby invited to submit their comments, using the template provided, on this proposed guidance note to: PA-Standards@resbank.co.za for the attention of Mr Christiaan Henning and Mr Ashendran Padayachee, by no later than 13 September 2023.

Fundi Tshazibana

Fundi Tshazibana
Chief Executive Officer

Date: 01/08/23