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South African Reserve Bank
Prudential Authority

**Prudential Communication 10 of 2022**

**Climate–related risks**

***Objective of this Prudential Communication***

*This communication provides the initial views of the Prudential Authority (PA) on climate-related risks and their potential impact on financial institutions supervised by the PA. It aims to highlight the importance of considering the potential impacts from these risks on the business of financial institutions.*

## 1. Application

1.1 This Prudential Communication is applicable to all registered banks[1], mutual banks, licensed insurers and licensed financial market infrastructures supervised by the Prudential Authority (PA).

## 2. Purpose

2.1. The purpose of this Prudential Communication is to:

a. Provide an overview of the impact of climate change, climate risk[2] drivers and the interconnectedness to financial risks within the context of the regulatory and supervisory mandate of the PA;

b. Highlight the important role played by the boards and senior management of financial institutions in considering climate-related risks, and managing these risks in terms of governance, strategy, and risk management considerations; and

c. Describe some of the PA's current climate risk related initiatives as these relate to the PA's approach to oversight of climate related risks in supervised financial institutions falling within the regulatory and supervisory remit of the PA.[3]

## 3. Introduction

3.1. The effects of climate change have been recognised as an overarching global threat impacting human, societal, environmental, and economic systems through rising

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[1] Excluding co-operative banks, and co-operative financial institutions

[2] The National Treasury in its technical paper entitled "Financing a Sustainable Economy" and published in 2021 referenced climate risk as climate change and greenhouse gas emissions but may also include considerations that are cognisant of wider environmental factors and associated risks.

[3] The NT paper "Financing A Sustainable Economy" identified that managing and disclosing climate risk was an area of urgent demand for the financial sector, building on international standards such as those of the Financial Stability Boards Taskforce on Climate-related Financial Disclosure (TCFD). Include the work on "Guide to climate scenario analysis for central banks and supervisors by the Network for Greening the Financial System: https://www.ngfs.net/sites/default/files/medias/documents/ngfs_guide_scenario_analysis_final.pdf

global temperatures, rising sea levels and an increasing frequency/severity of natural catastrophes and extreme weather events.[4]

3.2. Climate–related risk is regarded as a systemic risk and acknowledged globally by central banks as a financial risk which affects financial stability.[5] The effective management and mitigation of such risks is important to central banks and supervisors in terms of ensuring a financial system that is resilient to these risks.[6]

3.3. The severity and impact of climate change has been explicitly illustrated domestically in recent times through incidences of flooding, droughts, and wildfires across most of South Africa's provinces. Climate-related risks materialise further as economies adopt and implement measures to shift towards scenarios that lower greenhouse gas emissions, which has significant financial implications for the entities supervised by the PA.

3.4. The PA, in terms of its statutory objectives and mandate, has embarked on various initiatives through its Prudential Authority Climate Task Team (PACTT). The initiatives are aimed at promoting and developing a regulatory and supervisory response to climate risks impacting supervised institutions.

3.5. Supervised institutions that have a comprehensive understanding of the impact of climate risk will be better positioned to formulate and implement risk management and mitigation processes that could enhance financial resilience and inform appropriate strategic and business decisions.

3.6. The Prudential Communication provides an outline of the financial risks stemming from climate change together with the PA's considerations and expectations of banks, insurers, and financial market infrastructures.

## 4. Financial Risks Stemming from Climate Change

4.1. The impact of climate change on traditional risk categories usually considered by supervised institutions (e.g., credit risk, market risk, underwriting risk, operational risk, liquidity risk and reputational risk) could be significant.[7] The multi-dimensional nature of the risks arising from climate change present significant challenges to supervised institutions in relation to the traditional approach to financial risk identification and quantification. This is especially so given the unique characteristics of climate related financial risks which include the extensive breadth and magnitude of the risk, including its uncertainty over prolonged time horizons. There is also the inevitability of certain shocks regardless of measures taken, which require pre-emptive measures to build resilience and adaptability among supervised institutions.

4.2. Financial risk impacts will manifest through two primary transmission channels being physical and transition risks.

[4] IAIS – Application Paper on the Supervision of Climate-related Risks in the Insurance Sector. October 2020.
[5] As defined in the Basel Committee on Banking Supervision "Climate-related financial risks – measurement and methodologies. https://www.bis.org/bcbs/publ/d518.pdf
[6] (NGFS, A call for action – Climate change as a source of financial risk, 2019)
[7] Climate related risk drivers and their transmission channels (bis.org)

4.3. Physical risk arises from the materialisation of climate change and environmental degradation. These can further be expanded to chronic physical risks and acute physical risks.[8]

a. Chronic physical risk refers to those risks that will arise due to the gradual change of climate patterns over time. These include for example changes in wind, air and sea temperature, water levels and precipitation patterns.

b. Acute physical risks refer to event-driven hazards that are becoming more frequent and more severe because of climate change. These events include floods, droughts, storms such as hailstorms and cyclones, and heatwaves.

4.4. Physical risks could have an impact on financial institutions' assets and liabilities as well as operations through for example supply chain disruptions and/or damages to its own property.

4.5. Financial institutions invest in, finance and/or provide insurance for property and infrastructure that could be damaged by either acute or chronic climate-related events. In addition, financial institutions also invest in other entities of which their economic activities could also be impacted. This could lead to investment, credit and underwriting losses and ultimately influence the financing and insurability of future developments.

4.6. Transition risk refers to those risks associated with a global and domestic transition to a low greenhouse gas economy. These could include changes in climate-related policy and regulation, changes in the behavioural patterns of individuals and businesses (relative to climate change) and the emergence of new technologies and business models. It also relates to the net zero plans and policies of current and future trading partners and the overall pace at which the transition will occur.[9]

4.7. Low greenhouse gas emissions are crucial to keep global temperatures within an acceptable range, building resilience to potential unreversible consequences of climate change and positively affect the frequency and severity of future physical climate-related events.

4.8. Increasing awareness of the importance of lowering greenhouse gas emissions has started to drive diverse initiatives globally and locally that will result in changes to the risk and return profile of certain economic activities and associated financial assets and liabilities but also present numerous opportunities in terms of new types of assets and products for the financial sector.

4.9. Supervised institutions, their boards and senior management would need to deal with changes to the valuation, pricing, and insurability of affected assets as individuals, businesses and governments adapt their economic behaviour to the effects of climate change.

4.10. Furthermore, it is important to consider the potential social risks that may arise as a consequence of these behavioural changes required to reduce greenhouse gas emissions. These include for example impacts on societies, communities and individuals that may be strongly tied to certain economic activities.

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[8] (NGFS, A call for action – Climate change as a source of financial risk, 2019)
[9] (NGFS, A call for action – Climate change as a source of financial risk, 2019)

## 5. Expectations

5.1. Given the potential financial impacts described above, it is important for supervised institutions to enhance their knowledge and understanding of climate-related risks and how their business models could be influenced and affected by it.

5.2. Supervised institutions should consider climate-related risks as part of their governance, risk management and internal and external reporting frameworks and identify any consequential impacts on their strategies and business plans. It is also important to take appropriate actions to build and/or increase resilience to such effects.

5.3. Supervised institutions should identify important climate-related information to be disclosed to stakeholders and include it as part of their disclosure frameworks. The recommendations issued by the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) could serve as important guidelines in this respect.

## 6. Way Forward

6.1. The PA will continue to advance its approved climate risk initiatives through the PACTT. The initiatives are geared toward capacity building and the enhancement of the PA's regulatory and supervisory frameworks and practices.

a. The PA is in the process of developing supervisory guidance for frontline supervision departments that will assist supervisory teams in their climate-related engagements with regulated entities.

b. The PA will issue specific regulatory guidance in 2023 on its expectations on how climate risks should be integrated into supervised institutions' risk management, governance and reporting processes in accordance with its internal roadmap. This regulatory guidance will be aligned with emerging international best practice.

6.2. The PA will augment its supervisory monitoring capability of climate risks in 2023 through business-as-usual supervision across all supervised institutions. To this end the PA will start to monitor how supervised financial institutions have approached the integration of climate risk into their governance, risk management and reporting processes.

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**Chief Executive Officer**

Date: