THE DEPUTY LEADER OF THE HOUSE OF LORDS

The Rt Hon Baroness Kramer
House of Lords
SW1A 0PW

9 April 2021

Dear Baroness Kramer,

Following the Report stage debate on the Financial Services Bill on Wednesday 24 March, I committed to write to you to about the Bank of England's ("the Bank's") Climate Biennial Exploratory Scenario (CBES) – which will be conducted later this year – and how it relates to capital requirements for banks.

The CBES is primarily a learning exercise. As I said during the debate, the quantification of climate risks is new territory for firms, and what good practice looks like is still being determined. To facilitate this learning, the objectives of the CBES are to assess the risks from climate change to the financial sector, to identify if those risks could give rise to challenges to current business models, and to improve how firms embed climate risks into their risk management.

Quantifying climate-related risks is currently difficult because of gaps in modelling techniques and data availability. The Bank of England has been engaging with firms to improve their abilities in these areas. To allow firms to focus on further developing these capabilities, the CBES makes several simplifying assumptions. For instance, unlike traditional stress tests that are used to set capital requirements, the CBES is a scenario exercise that assumes firms' balance sheets remain fixed during the modelling horizon, and abstracts from profit and loss modelling. These assumptions allow firms to focus fully on risks to their existing business under different future climate scenarios.

Setting capital requirements to account for potential climate-related losses requires a good understanding of climate-related risks. The CBES is a crucial first step in developing that understanding. But because of the simplifying assumptions made for this first exercise, it is not yet well-suited for calibrating capital requirements.

This approach is similar to that being taken by other central banks and supervisors considering climate-related scenario exercises. The Bank has been working closely with its international counterparts on these issues, through the Network for Greening the Financial System, and it chairs the workstream overseeing the development of climate reference scenarios. In addition, the Bank has been supporting the work of the Basel Committee Task Force on Climate-related Financial Risks, which is examining how climate-related risks are transmitted, measured and assessed in the banking system.

The CBES will promote a better understanding of vulnerabilities in firms' business models, and will prompt supervisory actions of a microprudential nature where necessary – for example, if a firm should need to address identified vulnerabilities to protect its safety and soundness. This exercise is also likely to promote better climate disclosures by firms, as it helps them to improve their data, modelling, and risk management capabilities.

I would also like to draw your attention to the Bank's Supervisory Statement 3/19[1], published in April 2019, which has asked firms to set out how they have ensured that they are holding sufficient levels of capital to withstand potential climate related losses. The responses to this question will provide further insight into potential gaps and capital vulnerabilities.

I am copying this letter to all those who spoke in the debate on 24 March, and I am placing a copy in the Library.

Yours sincerely,

EARL HOWE

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1 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2019/ss319