

# BANK OF ENGLAND LAUNCHES CLIMATE BIENNIAL EXPLORATORY SCENARIO

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Legal Briefings

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On Tuesday 8 June, the Bank of England launched its Climate [Biennial Exploratory Scenario \(BES\)](#), a stress-testing exercise on the financial risks from climate change. While the regulator's rhetoric may sound like a call to arms, the BES hopes to understand the issues the financial system faces to ensure that real change is effected by UK financial institutions and insurers in response to the challenges of climate change. Participants have until mid-October 2021 to make their initial submissions, with the results expected to be published by the Bank of England in May 2022.

The Bank of England has long been championing the need for the financial services and insurance industries to prepare themselves for the oncoming risks and challenges which may arise from climate change.

The BES had been planned for launch in Q2 2020 but was postponed as a result of the COVID-19 pandemic. It will test the resilience of the largest UK banks and insurers, as well as the UK financial system more generally, to climate-related risks. The launch follows a detailed consultation process with industry, climate scientists and other stakeholders.

## WHAT WILL THE BES ACHIEVE?

The Bank of England hopes that the BES will help itself and participants to:

- assess the scale of the potential financial exposures facing the system and the individual

participants as a result of climate-related risks;

- understand the challenges which firms' business models may face as they consider their responses to climate-related risks; and
- better understand the interdependencies within the financial system, including the impact of changes in the insurance market on other parts of the financial sector.

The BES is framed as a learning exercise. Assessments of climate-related risks to the financial sector remain in their infancy, and both the participants and the regulator stand to learn much from the BES.

In addition to modelling financial risks, the BES looks to gain an understanding of firms' governance and policy frameworks to test their resilience to potential challenges.

The lessons learnt from the BES may quickly form the direction of travel for the prudential regulation of the UK financial sector in relation to climate-related risks, although the Bank of England has made clear that there are no current intentions to use the exercise to set capital requirements.

## **WHAT DOES THE BES CAPTURE?**

The BES represents the first instance of an exploratory stress test of the UK financial services industry to the oncoming challenges posed by climate change. The BES will look at climate-related risk both in terms of physical and transition risks facing the sector, such as, for example, flooding risk and risk of policy changes.

Participation will be made up of just under twenty of the largest UK banking groups, building societies and insurers. Due to the nature of the exercise, the results are intended to be published on an aggregated basis to reflect systemic risks.

The BES asks participants to adopt three climate scenarios: Early Policy Action (where transition begins in 2021), Late Policy Action (where transition begins in 2031) and No Additional Policy Action. Guidance has been given to the physical and transition risks associated with each scenario.

The Bank of England has sought to frame the otherwise vast and dynamic risks in its suggested scenarios and proposed time horizons. The proposed 30-year time horizon for the BES extends out beyond those normally adopted by financial services stress testing to reflect the long-term challenges posed by climate change.

In addition to the scenario analysis and the sizing of the participants' credit risk (based on their current, fixed balance sheet exposures), participants will also be invited to complete a qualitative questionnaire describing their approach to risks, risk management, consideration of climate litigation risk, and potential management actions in response, as well as producing detailed counter-party level analysis for their largest counterparties, differentiated by geography and sector. The BES will therefore adopt both a drains-up and a top-down approach to understanding the challenges facing the financial sector from climate-related risks.

## TIMING

Participants' initial submissions will be due in mid-October 2021, with the scope for a further round of the exercise expected in early 2022, and anticipating the publication of the results in May 2022.

## KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



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