

# ADDRESSING SUSTAINABILITY RISKS IN THE FINANCIAL SECTOR

## **Physical risks, liability risks and transition risks challenge policy makers**

In 2015 ahead of the Paris agreement, Governor Carney stated that there are three broad channels through which climate change can affect financial stability: physical risks, liability risks and transition risks. Some NGFS (Network for Greening the Financial System) members have extended their analysis to broader environmental risks finding that these are a source of financial risk as well.

The consequences of liability risks – i.e. the claims of parties who have suffered loss or damage from the effects of climate change, seeking compensation from those they hold responsible - are well illustrated by PG&E that recently entered under Chapter 11 bankruptcy protection: this insolvency is due to the expected costs of the class actions triggered in the wake of the devastating wildfire that swept through northern California in 2018. The exact cause of most recent fires in California remains undetermined. But the State's climatic and hydrological conditions, further deteriorated by global warming, are favourable to such fires.

More generally, anticipating the potential reassessment of the value of a large range of assets triggered by potential changes in policy, technology and physical risks is challenging.

Finally, the possible magnitude of the impacts on insurance liabilities and the value of financial assets that arise from climate- and weather-related events is amazing.

Furthermore, the size of such a challenge is magnified by the fact that these risks will be highly influenced by policy choices that are under the responsibility of elected governments. In addition, unfortunately, as these risks are a function of cumulative emissions, earlier (later) action will mean less (higher) risks. This means that, since the negative impacts of climate change will occur beyond the traditional horizons of those policy makers, they will lag behind.

This is what Governor Carney named the tragedy of the horizon.

## **EU Supervisory authorities started the process to better integrate sustainability risk in regulatory frameworks**

In this context, the EIOPA received a call from the European Commission to provide technical advice on potential amendments to or introduction of delegated acts under the Solvency II Directive and IDD with regard to the integration of sustainability risks and sustainability factors. This Call for Advice refers particularly to the following areas:

The EIOPA ended a consultation in January 2019 on possible amendments to the Solvency II Delegated Regulation aimed to ensure the identification and assessment of sustainability risks in the areas of underwriting and investments. In these amendments, insurance undertakings are expected to take

into account the potential long-term impact of investment decisions on sustainability factors (stewardship principle) and, when relevant, reflect policyholders' Environmental, Social and Governance (ESG) preferences.

The EBA for its part stressed that without common definitions and metrics, trying to quantify the magnitude of un-sustainable exposures in banks' balance sheets, remained a key challenge when using supervisory reporting data. This is also the reason why the development of a taxonomy is one of the main priorities on the European Commission's agenda.

Yet, the EBA includes in its 2019 workplan a contribution to the Commission's work on sustainable finance, particularly regarding the taxonomy for sustainable finance and green bond standards, as well as the specific mandate given to the EBA for advising on the feasibility of green/brown supporting/penalising factors in the bank prudential framework, as included in the action plan for sustainable finance.

In the short term a telling piece of information is that EBA has earmarked certain sectors as potentially non-green, and that according to the EBA, EU banks' total exposure to these sectors amounted to 2,049,037 EUR m, in June 2018. The EBA assess the riskiness of certain of these sectors considering their expected default frequencies e.g. mining and quarrying that rank first among potentially carbon-intensive sectors, followed by construction.

## **EBF/Bruegel controversy**

The European Banking Federation (EBF) on its part is of the opinion that encouraging green loans is a sensible idea. It stressed on the one hand that a "punishing" factor could negatively impact adequate risk management notably in the context where globally there is no clarity about the definition of 'brown', while there is a lack of reliable data on the way that 'brown' companies affect the climate. Conversely, it stressed that a supporting factor would mean banks committing less capital for loans what would effectively contribute to accelerating the transition to a sustainable, climate-neutral economy, incentivise economic players in the right direction provided that a green supporting factor should realistically reflect the real risks for such green loans.

On the contrary some argue that "a much stronger case that can be made for a "brown penalising factor" to discourage further investments that contribute to climate change and enhancing the resilience of financial players.

However, this debate risks hiding important questions, which deserve to be carefully sorted out avoiding too comfortable intellectual shortcuts.

The first issue is that one challenge specific to climate related risk is that these are future risks that require new forward-

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looking assessment tools. One consequence in this respect, is that at the moment nobody even knows whether brown or green assets actually yield or not significantly and to what extent measurable risks exist and in which time horizon.

The second issue is that it is naïve to think that the physical risk on an institution's portfolio will be mitigated by just penalising "brown" assets since they are generally not more exposed to adverse climate related risks than others. Similarly, it is naïve to assert that "green" assets are per se better positioned risk wise. In the same vein appropriate climate change related policies are able to alleviate the uncertainties weighing on "brown" assets and related risk, by providing appropriate forward guidance.

The third issue is related to the ability of prudential frameworks to provide incentives. There the answer is definitively yes, they do! Indeed, regulatory capital consumption drives the performance of activities, the profitability of transactions and ultimately business decisions. Accounting and regulatory capital rules cannot be neutral as they directly impact institutions' behaviour.

Fourthly, furthermore, expected and unexpected incentives are already provided by the existing accounting and regulatory environment. One should bear in mind in particular that they all play against long term investments. Indeed, most emerging (positive or negative) externalities - due notably to their the long-term nature - are usually not taken into account since existing rules look backward. This issue should be addressed notably by factoring in sustainability considerations.

Neutrality is highly dependent on what one is trying to measure.

## The way forward

Work is needed to assess whether a financial risk differential exists between "green" (low-carbon) and "brown" (carbon and pollution-intensive) assets.

Competent authorities and financial institutions also need to develop new analytical and supervisory approaches, notably based on long-term forward-looking scenario analysis and stress tests, in a context where historical data is not sufficient to assess the risks. This represents an unprecedented change of the current risk assessment and mitigation paradigm.

In addition, assessing the possible effective and balanced roles that a prudential framework could play to incentivizing financial institutions in order to accelerate the shift of economies toward green finance, remains essential. This should complement the fact that some central banks, regulators and local authorities have already introduced incentives for banks to increase green lending and for issuers to issue green bonds.

In this context the NGFS will carry on its work on the following deliverables which will feature in its first comprehensive report to be published by April 2019:

- Narrowing down the complexity of risk analysis, e.g. through the development of a small number of high-level scenarios;

- Analysing the outcomes of the stock-take of supervisory and macro-prudential approaches to enhance firms' financial risk management, assess systemic risks and support disclosure;
- Analysing potential risk differentials between "green" and "brown" assets;
- Identifying some specific areas for Central Banks and Supervisors to "lead by example" notably integrating climate-related criteria in a growing number of their operations.

However, at this stage, the NGFS stressed that "the quality and availability of data is limited, taxonomies and definitions are still developing and there is a need to build intellectual capacity in translating the science into decision-useful financial risk assessment information".

In any case static disclosure appears to be a necessary short-term step. However, Governor Carney suggested that governments might complement disclosure by giving guidance on possible carbon price paths in order to avoid making the transition path bumpy. He suggested a possible carbon price corridor that should involve an indicative minimum and maximum price for carbon, calibrated to reflect both price and non-price policy actions, and increasing over time until the price converges towards the level required to fully translate the expected externality. Even if the initial indicative price is set far below the "true" cost of carbon, the price signal itself holds great power.

Finally, the important challenge beyond an appropriate anticipation of climate related risks of each asset, is to calculate the general impacts on society (externalities) and to translate them into monetary values. It would first internalise the externalities in the relevant balance sheets. It would also provide a monetary perspective of the potential impacts of possible policy changes, notably on asset values and business models. Not only would this actually reallocate appropriately the cost of negative expected externalities and provide an effective economic opportunity for correcting this externality by mitigating global warming, but it would also provide an efficient guidance which should contribute to avoiding sudden and deep asset price corrections, possibly threatening systemic stability. ■