Mitigating climate risk in the financial sector

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Climate change: a global issue at the top of the European regulatory agenda

Central bankers and supervisors should consider financial risks related to climate change in order to ensure the resilience of the financial sector as well as the accurate pricing of these risks. This has been the stance of the Network for Greening the Financial System, co-founded in 2017 by the Banque de France, who hosts its secretariat, and which gathers now more than 60 members around the globe. This "club of the willing" called standard setters for action and led the way by providing some strong analytical foundations and practice oriented deliverables. In 2020, it will release a guide for banking and insurance supervisors on how to integrate climate-related and environmental risks in their work, as well as a set of reference scenarios capturing the macro-financial impact of transition and physical risks related to different transition pathways. The NGFS will also publish a report on the current practices of financial institutions in monitoring these risks, highlighting the challenges arising from the lack of homogeneous taxonomy.

The European Union understood well the need for a green taxonomy, with the related regulation being officially released soon. This taxonomy, if complemented in the future by a "brown" one to classify assets with a negative environmental impact, will be a building block for supervisors to tackle ESG[1] risks. On the banking side, the EBA released in December 2019 an action plan for sustainable finance which entails in particular reports by 2021 and 2022 on the inclusion of ESG risks into the annual supervisory review process (SREP) and then into the pillar 3 disclosure framework. The EBA will also assess the relevance of applying a different prudential treatment on assets from a sustainability perspective by 2025. The EIOPA is addressing ESG risks for the insurance sector as well. To foster internal risk assessment by insurers, the EIOPA will finalize scenarios of climate related risks by the end of 2020. Both ESAs will conduct sensitivity analysis related to the impact of climate change on the insurers and banks' balance sheets. In the EBA exercise, participating institutions will identify the share of their exposures consistent with the European taxonomy.

At national level, the ACPR launched in 2020 a pilot exercise (with no impact on capital requirements) for banks and insurers, aiming at measuring the impact of various transition scenarios on the French financial sector. On the other hand, in 2019, the ACPR established a Consultative Commission on Climate and Sustainable Finance to monitor commitment taken by financial institutions, in particular to reduce the financing of carbon intensive activities.

The next challenge to face is to integrate climate risk into the international standards. In this perspective, the new High Level Task Force on Climate Related Financial Risks established by the BCBS is a very positive first step to ensure a more homogeneous understanding of climate related risks by institutions and supervisors. Standard setters should preserve this momentum despite the current crisis, as the risks created by climate change are still ahead of us. ●

1. Environment (including climate-related), Social and Governance risks.

Diony Lebot

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A fair regulation for sustainable finance: balancing constraints with incentives

Integrating ESG considerations into the banks' strategy and governance becomes increasingly important in view of the climate emergency but also as shown by the Covid-19 crisis. In this context, two major issues arise: the first relates to the risks carried by banks, while the other is on the role banks play towards the economy, their employees and all related stakeholders.

New banking regulations will help clarify and harmonize at EU level the existing ESG approaches implemented by banks. These should cover both risks and financial stability issues and provide the right incentives to allow for a real shift towards sustainable investments.

Firstly, while there is no doubt that climate risks could be a source of financial risks, ensuring a harmonized approach as well as tackling methodological issues are a prerequisite before any specific prudential treatment of exposures is agreed. In this respect, the Network for Greening the Financial System is doing essential work to provide a harmonized supervisory toolbox to define risk management mechanisms. The climate scenario analysis that will be conducted as of 2020 by supervisors should also help in developing a consistent approach. However, key challenges of methodological nature still need to be addressed with respect to data availability and consistency, mismatches of time-horizon between sustainable investments and loan maturities, and the complex integration of banks and clients' long-term strategies, as well as regional discrepancies while operating global businesses.

Secondly, many European banks already have made strong commitments to speed up the redirection of capital flows, by agreeing to the Principles for Responsible Banking or by progressively realigning their portfolio with the Paris targets. Going further, the EU taxonomy should help the identification of activities which are aligned with those commitments. A clear concern however is that the framework's narrow restriction to activities that could be carbon neutral in the very short term could undermine banks' capacity to finance transitioning sectors or companies that are well engaged on a decarbonization path.

Thirdly, data availability is a pressing issue: only EU large corporates are subject to non-financial reporting requirements. To avoid undermining banks' capacity to finance SME as well the development of emerging economies, the framework will need to consider how this data gap should be reflected into banks' own reporting requirements.

Finally, while the spotlight is currently on the climate emergency, sustainable development must also address social impacts. The pace of the transition will not be the same in all geographical areas: this calls for a differentiated treatment as clearly stressed by the Paris agreement at its inception. Indeed, banks play a decisive role to ensure that the energy transition is as fair and as inclusive as possible. Social considerations should be carefully evaluated for each new regulation including environmental ones. In that respect, governments will have to increase their commitment and accompany the necessary transition, and collaboration of private and public sector is of essence.

Daniel Hanna

Global Head, Sustainable Finance,
Standard Chartered Plc

Understanding, mitigating and tackling climate risk and climate change

Regulators are rightly concerned by the potential risk to financial stability posed by climate change. We are very supportive of their efforts. We are also mindful that while everyone in finance has a collective duty to protect the financial sector from climate risk, we must not lose sight of the critical role finance needs to play in preventing climate change itself. This is especially true in Asia, Africa and the Middle East, where we do most of our business. These markets face the greatest risk from climate change and the greatest opportunity to leapfrog to low carbon infrastructure and technology.

We believe that focusing purely on protecting the financial system, excluding considerations of how we finance the transition to low carbon, could even lead to an unintended consequence of making climate change more likely by raising the cost of private sector finance and locking countries into higher carbon pathways. We believe that transitioning to a low carbon future shouldn't come at the expense of lifting living standards, especially in countries where millions who remain in poverty have contributed the least to climate change and are the most vulnerable to it.

Capital and innovation are currently not moving fast enough or to the right places to support the needed transition to a low carbon world. Our recent Opportunity2030 study highlights a $10 trillion opportunity to support sustainable growth in emerging markets. In line with our findings, we've set ourselves ambitious targets to finance and facilitate $75bn of clean technology, renewables and sustainable infrastructure by the end of 2024. We have also framed our lending around the SDGs as evidenced in our Green & Sustainable Product Framework.

The lack of reliable data is a key impediment to tackling climate change. Data, like the information presented in Opportunity2030, is important to understand the potential risk around climate change, the opportunity to invest in the transition, and to track our progress in tackling both. This is one of the many reasons that we have long supported TCFD reporting. However, the uptake in many markets remains slow and carbon data for most of the real economy, especially in unlisted sectors and emerging markets is still absent.

Consistent and trusted frameworks help markets develop. Green bonds have grown more than six times in volume since the announcement of the Green Bond Principles for example. However, given how fast our understanding of ESG is evolving, we should be careful not to overly focus on nomenclature at the expense of impact. A transition bond helping an emerging markets energy company pivot away from coal may well be more impactful than a European green bond backed by retrofits of commercial real estate. A consistent framework for measuring transition and impact is critical.

Ultimately, a global challenge requires coordinated solutions. Developments like the NGFS and IPFS are positive signs that regulators are thoughtful about bringing together global standards. We would welcome the same partnership across private and public sectors to ensure that we can develop the right data and standards to encourage transition to happen during the 2020s, the decade of delivery.

Elizabeth Gillam

Head of European Government Relations and Public Policy, Invesco

Redefining risk and reward for the climate transition

Addressing climate change will require significant and sustained deployment of capital to finance the transition to a sustainable and climate neutral economy. In Europe, the fund, insurance and pensions sectors represent €17tn, €10tn and €4tn respectively of patient capital to be deployed to achieve this goal. In seeking to leverage these pools of capital to support the climate transition, we need to give equal weight to both the risks and opportunities relating to climate change.

A core function of markets is pricing risks. But assessing the financial impacts of climate risks represents a unique challenge – how to price in a risk where the timing and impact are uncertain. The usual disclaimer that "past performance is no guide to future performance" has taken on a whole new significance in the debate around climate change. Firms and supervisors are increasingly turning to scenario analysis to address these challenges by allowing firms to model the financial impact of different climate transition pathways. However, undertaking scenario analysis is a complex exercise, and is only as good as the assumptions underlying the scenarios against which a portfolio is assessed. The Network for Greening the Financial System is showing leadership in this area and we look forward to the publication of their work on scenario analysis in due course. This is uncharted territory for firms and supervisors alike, and an area where public-private collaboration and capacity building would be of mutual benefit as we seek to chart a path through the uncertainty.

Encouraging early action on climate change is critical to avoid the "tragedy of the horizons" described by Mark Carney. To achieve this, we need to crowd-in investors and companies that are heading in the right direction and ensure that such actions are rewarded in the markets. We are increasingly seeing markets pricing in a so-called "greenium" for companies that are actively taking steps to transition to a net zero world. The Taxonomy could accelerate this trend by providing investors and companies with a common, science-based framework to assess which activities are compatible with the Paris Agreement. However, the strong price signal that European investors can send by coalescing around the Taxonomy risks being diluted in a global marketplace. Other jurisdictions are also developing their own tools, as well as the many industry-led initiatives such as the Transition Pathway Initiative and Science-Based Targets. The International Platform on Sustainable Finance could play a key role to play in the next phase of the Sustainable Finance Strategy to begin building international convergence in this space.

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To accurately assess both risk and reward, reliable data is critical. The Task-Force for Climate-related Financial Disclosures has quickly become the key reference framework for climate-related disclosures for over 1,000 global organisations representing $12 trillion of market capitalization. However, as laid out in its latest progress report, companies are still not disclosing enough decision-useful information. Addressing the data gaps will be of vital importance both for investors and supervisors to better assess both the risks and opportunities inherent in the transition to a net zero economy. ●

Eugenie Molyneux

Chief Risk Officer Commercial Insurance, Zurich Insurance

ESG considerations, business and regulatory challenges and opportunities

Environmental, social and corporate governance (ESG) considerations increasingly influence insurance companies in their role both as investors and as underwriters. Defining the ESG topics to focus on is a challenging ask and an extensive process. As views of internal and external stakeholders (investors, customers, employees, regulators) diverge, Zurich drives a data driven materiality analysis and a three-staged approach to identify, assess and develop sustainability risk positions on difficult ethical issues.

Sustainability risk positions are implemented and operationalized in the business and translated into underwriting practices, recommended business actions and along the product development process. Because we do not to underwrite or investing in thermal coal, oil sands/shales and banned weapons businesses, balancing our own ESG considerations against ▶

those taken more broadly by the market is challenging. Indeed, if the market and/or country, are not yet also focused on the transition to a low carbon economy, it can create the environment for poor relationships with those stakeholders and a difficult business environment. Therefore, Zurich Insurance believes it is key that companies across all sectors of the economy start to analyse and understand the impact climate change could have on their business.

This is an ongoing process and the development of the EU taxonomy will help all sectors comprehend sustainability risks. Zurich Insurance Group supports the international and European initiatives focused on promoting sustainable policies and a progressive transition to a low-carbon economy. However, limiting climate change to 2°C or below will lower physical climate risk, the technological and policy changes required create their own set of risks. Some potential drawbacks can arise from legal uncertainty and complex regulatory requirements resulting in insurers being subject to unnecessary liability risks and clients and investees having difficulties in applying them.

Achieving a transition to a low-carbon economy will require fundamental changes to our society and economy.

Consistency needs to be ensured between the increasing number of reporting and investment regulation (the revised EU Non-Financial Reporting Directive, the Sustainable Finance Action plan and the EU Green Deal). Flexibility in implementation and an adequate level of details in ESG disclosures are required to avoid creating an additional level of barriers. Information overload, duplication, prescriptive and overly detailed ESG disclosures should be avoided. Sound risk assessment should underpin every investment decision.

Green or sustainable investments are not necessarily less risky than more traditional investments. Hence, Zurich does not support a 'green supporting factor' or a penalising 'brown factor'. We would prefer to price externalities at their source, not through insurers capital requirements. When inadequate they may also have the unintended consequence of slowing down the transition. New green industries due to the degree of uncertainty around new risks might require additional capital loading. The cost of insurance and/or appetite of insurers would then impact negatively the transition. It is vital for insurers to manage their total exposures to protect both the company and its customers. Data currently not easily accessible are crucial to invest and to underwrite. Policymakers could play a crucial role in designing mechanisms improving data availability, quality and comparability.

Stefanie Ott

Head Group Qualitative Risk Management, Swiss Re

Accelerating sustainable progress in the financial sector and beyond

Sustainability has become a strategic, long-term value driver in the financial sector. By managing and monitoring risks and opportunities associated with environmental, societal and governance (ESG) issues, Swiss Re helps to accelerate the transformation towards a more sustainable economy. Among the wide array of sustainability topics, climate change remains one of the key topics for the industry.

Tackling this topic effectively is challenging and needs a true multi-stakeholder effort. We therefore set an emphasis on our own risk research and partnerships, on product solutions to adapt to the effects of climate change (through e.g. NatCat protection) and low-carbon transition opportunities (through e.g. wind and solar power plants).The topic remains relevant for our re/insurance business, our investment side as well as for our operations. To take a concrete example the wildfires in Australia, Canada and USA increased in frequency and have been linked to climate change. While not a systematic loss in respect to scale, the fires proved that climate change can have effects not considered before. Over the past years, we have witnessed the initial incorporation of sustainability into prudential and conduct regulation across the financial sector at international and regional levels across the globe. From a global perspective, we are part of the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) which has developed a set of recommendations to ensure consistent climate-related financial risk disclosures by companies to the market and continues to push for widespread international voluntary adoption of this standard across all financial services sectors.

Sustainability is a strategic, long-term value driver in the financial sector. Swiss Re supports the transformation towards a sustainable economy.

The International Association of Insurance Supervisors (IAIS) together with the Sustainable Insurance Forum (SIF) has been supporting the TCFD's work and is raising awareness of the challenges presented by climate change for insurers and supervisors, mapping out how these issues could be tackled. More recently, Central Banks and Supervisors established the Network for Greening the Financial System (NGFS) which aims to mobilise capital for green and low-carbon investments and identify what

measures are needed to manage financial risks related to climate change.

In most cases, such emerging regulation includes disclosure requirements for insurers' exposure to climate change risks. These efforts intend to achieve more transparency about how sustainability issues affect an organization's businesses, investments, strategy and financial planning.

The regulatory response to the climate change threat is often driven by the political situation in the respective jurisdiction. Political forces increasingly exert pressure on regulators to move capital to a low-carbon economy. Voluntary disclosures of climate-related financial information will likely become mandatory in a couple of years. However commendable this may be, fragmented or overly onerous requirements should be avoided. Consequently, what our industry needs is a harmonized and gradual implementation and therefore an intense discussion of decision-useful disclosures.

We believe that climate-related financial disclosures should be aligned across different regulatory jurisdictions in order to enhance the transparency and comparability between firms operating across different geographies, to ensure a level playing field and to reduce the operational burden on global firms. We will support mandatory disclosures after they will have become decision-useful and best-practice learnings / experience from the industry have become more established.

Fausto Parente

Executive Director, European Insurance and Occupational Pensions Authority (EIOPA)

Climate change: the role of insurers in mitigating risk

Sustainability, and in particular climate change, has been a very important part of the political agenda for some time and the success of the sustainability agenda depends to a great extent on the capacity of financial market participants, including insurers, to incorporate the expected long-term consequences of climate change and environmental, social and governance issues into today's risk measurement and decision-making processes.

EIOPA has been working on a number of policy proposals, tools and methods for identifying and managing sustainability risks, including climate change. Without doubt climate change brings considerable challenges to the valuation of assets and liabilities, underwriting and investment decisions and risk measurement. This is because climate change increases the uncertainty about the occurrence and the impact of physical or transition risks, which can happen at any time and suddenly, with far-reaching consequences. Hence, undertakings should not be complacent about these risks.

EIOPA has therefore also included natural catastrophe scenarios in its stress testing of the insurance sector in Europe and our most recent stress test, completed in 2018, participating groups demonstrated a high resilience to the series of natural catastrophes tested, showing the importance of the risk transfer mechanisms, namely reinsurance, in place.

Another element of EIOPA's work has been to integrate environmental, social and governance factors into existing regulations. Regarding Solvency II, in our Opinion, published in September last year, EIOPA addresses the integration of climate-related risks in Solvency II Pillar I requirements.

Overall, Solvency II - as a risk-based, forward-looking and market-consistent framework - is well equipped to accommodate sustainability risks and factors and the Opinion outlines how insurers can contribute to identifying, measuring and managing risks arising from climate change, through their investment and underwriting activities. It is for this reason therefore that insurers and reinsurers should implement measures linked with climate change-related risks, especially in view of a substantial impact to their business strategy and in this context EIOPA has stressed the importance of scenario analysis in the undertakings' risk management.

Insurers can also mitigate the risks of climate change by considering the impact of their own underwriting practices on the environment. In this way, insurers can increase market and citizens' resilience to climate change.

> *Insurers can play a stewardship role. As large investors, insurance groups are well-placed to incentivise and engage with business to act responsibly.*

Above all, insurers can play a stewardship role. As large investors, insurance groups are well-placed to incentivise and engage with business to act responsibly and ensure long-term value creation, playing therefore an important role in the gradual transition to a more sustainable and resilient economy. This stewardship role is more important than ever in contributing to climate change adaptation and mitigation.

Meeting the challenges of climate change requires concerted action from all players and EIOPA will continue to a role to secure a resilient and sustainable industry that is for the benefit of consumers.