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Encouraging sustainability – managing risk

Most environmental scientists now agree that climate change represents significant risks to society. Increased temperatures are causing the loss of glaciers and rising sea levels as well as extreme weather events such as droughts, storms and heatwaves. In Japan, heavy rains, floods and landslides have become more frequent and data from the Japan Meteorological Agency shows that the 10 years from 2010 to 2019 extreme rainfall events with precipitation of more than 400 mm per day -- the level likely to cause landslides or floods -- rose 170% compared with 10 years from 1976 to 1985. The possible relationship between the problem and climate change is pointed out.

Even a 1.5 degree C rise in temperatures above pre-industrial levels may bring catastrophic change. A managed transition to a sustainable, decarbonised future is essential and many are now urging policy makers and authorities to take immediate action. This requires a coordinated set of ambitious policy responses, backed up by regulations that are clear, consistent and broadly applied.

Such policies and regulations must seek both to encourage the move to sustainability and to force economic actors to manage the risks of climate change.

The approach of the EU Taxonomy regulation, broadly speaking, is to encourage the transition towards sustainability. It will drive the necessary change by creating a unified system for determining whether an economic activity or investment qualifies as environmentally sustainable. This introduces consistent criteria for labelling a product as “green”, which will be used by Member States and financial market participants respectively in the labelling and marketing of financial products.

Certain national regulators have focused on risk management. In the UK the PRA and FCA have encouraged regulated firms to manage climate change risk by requiring their Boards and senior management to focus on their risk management systems and controls and have co-chaired the Climate Financial Risk Forum, which has recently published guidance to advance the sector’s responses to the financial risks from climate change. This covers:

- Risk management – to enable better decision-making and resilience building;
- Scenario analysis – to assist in understanding and responding to future risks;

- Disclosures – to improve transparency and help stakeholders assess the future value of assets;
- Innovation – to encourage new services and products enabling a firm to respond to climate change and contribute towards a decarbonised economy.

The PRA has now consulted on plans for its 2021 Biennial Exploratory Scenario, which will be a bottom up stress test of the resilience of the UK’s largest banks to climate change risks, further informing the UK’s early-stage but comprehensive set of tools for assessing and mitigating climate change risks.

Banks are subject to the risks of climate change but as providers of credit and liquidity banks must be agents for change as well. The financial sector must encourage sustainability and at the same time manage its own risks. As ever, the winners will be those firms that respond best to the opportunities and obligations presented in the years to come. ●