**SESSION SUMMARY -** BERLIN SEPTEMBER 2020

# Will tackling climate risk still be a major priority post COVID 19 crisis?

### 1. The COVID 19 crisis opens a window of opportunity to leverage a win win policy paradigm by combining the relaunch of the EU economies while aligning them with the Paris Agreement and broader sustainability objectives

A Central Bank official suggested that the COVID crisis provides an opportunity for governments, financial institutions and regulators to create a paradigm shift and harmonise two different goals: re establishing global economies and aligning them with the goals of the Paris Agreement. The Central Bank official commended the European authorities for their ambitious strategy to align Europe's economies with the goals of the Paris Agreement. Europe is making this journey together, and it is something that governments, financial institutions and regulators must achieve in close harmony.

An industry speaker considered that action beyond financial assistance will be required to create a recovery consistent with the Paris Agreement. This might be a clear roadmap for the phasing out of fossil fuel subsidies or the introduction of a requirement on price externalities. In any event, it will be vital to establish a roadmap with a clear timeline and an explicit scope. This will help maintain the balance between incentivising businesses to transform and/or be resilient while not tipping the 'economic cart' over the edge. The COVID crisis demonstrated that numerous real economy businesses have vulnerabilities, which underlines the importance of not exacerbating their position.

### 2. The COVID crisis demonstrates how sustainability challenges are real and interlinked; creating better assessments of those risks is a policy priority

A Central Bank official noted that the COVID crisis has been a stress test of societies' preparedness for unpleasant but nevertheless foreseeable events. The world should not consider finance, health and environment as different silos but tackle these problems as one.

A Central Bank official explained some of De Nederlandsche Bank's work on shaping policy around the risks stemming from climate change and the broader area of sustainability risk. Tackling climate change will be a major priority after the COVID crisis. The threat of climate change is imminent; it is the same. The COVID crisis is a real life example of how exogenous shocks can impact the financial system.

An industry speaker stressed that the world cannot afford to deprioritise climate risk post COVID. If anything, COVID 19 is a lesson about the dangers of what can happen if the world fails to act on the warnings it is given. The industry speaker described how green investments comprised 16% of national stimulus programmes following the previous financial crisis. In today's crisis, this would be €550 billion. The European Commission estimates the gap in sustainable investment to be around €250 billion per year until 2030, which suggests a need to increase the green component in these stimulus measures.

A Central Bank official highlighted a recently published book called The Green Swan . Taking the analogy of the 'Black Swan', the book demonstrates that the consequences of climate events could be even worse and less predictable than a 'black swan' event. The world knows that the climate crisis will probably happen, but there are also solutions to be found and there is a degree of positive impetus.

An industry representative noted that climate change is a top priority for their firm and described how, in advance of the COVID crisis, research by the World Health Organization discovered that climate change could contribute to an increase in the severity and frequency of pandemics. The industry representative described how European policymakers were busily working on the sustainable finance agenda before the COVID crisis. The taxonomy published in March provides guidance on exactly which economic activities policymakers are considering green, transitional or enabling. The industry representative explained that climate change is already at the top of their firm's agenda, but this is mostly driven by clients rather than policymakers. Increasingly, institutional clients ask the industry representative's firm to integrate these factors into the distribution process. The industry representative added that their firm has developed a proprietary ESG rating system which scores investee companies on E, S and G factors.

A Central Bank official recommended the report Indebted to Nature published by De Nederlandsche Bank, noting that the report applies current thinking on climate change to other types of sustainability risk. De Nederlandsche Bank took the ideas of physical risk, transition risk and reputational risk from climate risk and discovered that they applied equally to the loss of biodiversity. Currently, De Nederlandsche Bank is working on how to apply this knowledge to supervisory frameworks.

A Central Bank official noted that agriculture could be massively impacted by the loss of biodiversity. The intensive consumption of meat and other agricultural products can damage habitats, but the agriculture industry might also be the first industry to be affected by this damage.

An industry speaker emphasised the need to consider the broader landscape of sustainability risks, because these risks are interconnected. It is important not to solve one risk and exacerbate another as a consequence, so the industry must consider the landscape holistically.

A regulator agreed on the importance of broadening the topic beyond climate risk. This process began with the EU's green taxonomy. The financial industry must work on a single methodology and try to broaden it slowly but steadily into other sectors. The regulator highlighted the global nature of climate risk. The speeds at which these sensitivities have been transported across the world have been very different.

### 3. Financial institutions confronting sustainability challenges face both credit and reputational risk

An industry speaker described how banks often state that they must address productivity and other issues before addressing climate risk. Overall, banks consider climate risk a priority, but they do not seem to want to do it immediately in full scope.

An industry speaker considered the three key risks of the COVID crisis for banks to be credit risk, cost management and consolidation. The crisis is not yet over, and the peak of additional loan losses is forecast to occur in the third or fourth quarter of 2020, or in the first or second quarter 2021 for SMEs. The industry speaker suggested that tackling climate change could help banks from a reputational point of view, however. One of the opportunities created by COVID 19 is the chance for banks to improve their reputations. For banks, being green could be beneficial. Clients are increasingly interested in banks' green credentials. Most banks do not consider climate risk as their highest priority, however, because they are focused on surviving the crisis. A Central Bank official noted that tackling climate risk is also about survival.

### 4. The financial sector must produce qualitative and quantitative harmonised data on climate change and develop forward looking and future proof risk frameworks

A Central Bank official observed that there is an emerging need for qualitative and quantitative data on climate change. Real economy companies should abide by TCFD standards. Financial institutions must disclose their data, and there should also be access to non financial information. In general, Europe needs more comparable and harmonised data. The Central Bank official stressed that the world does not need a plethora of different initiatives operated by global and local institutions; the world needs a harmonised set of comparable data so that forward looking and future proof risk frameworks can be developed.

An industry speaker described how their firm has received many requests for advice on sustainable finance in the past few weeks. It is easy to say that data is important, but acquiring it is a different question. The industry speaker compared the situation to mortgage loans. A lender can request information from their customer on energy consumption, but the lender cannot force the consumer to provide it. In practice, the problem is about data quality. The industry speaker noted the importance of ensuring that banks use relevant KPIs when providing loans. Banks must include all the main risks in their risk management frameworks. The industry speaker described how their firm uses a proprietary tool to value assets on the basis of climate impact.

A regulator stressed that the challenge here is broader than climate; it is about ESG overall. There are problems, but these are not reasons to stop tackling the crisis. There are data problems, but climate change is a bigger problem. Data is simply an instrument, and it would be incorrect to think that the problem does not exist simply because the instrument to measure it does not exist.

An industry speaker explained how banks are also establishing ESG committees to define their own ESG criteria according to their own perspective, because there is no common view on ESG. Banks who have established an ESG committee also using it as "second vote". The EU has developed the taxonomy, but it is difficult to understand and will take time to finalise. The industry speaker suggested that the good work being done by supervisors, regulators and politicians is somewhat like building a wonderful car and then asking banks and other market participants to drive it when there is no engine. The engine is the data.

An industry speaker praised the ECB's recently published guide on climate change and environmental risk, which focuses on business strategies, risk management, governance and disclosure. However, the document is only for banks in the eurozone; there are other banks in other parts of the European Union. Additionally, the world is not on a level playing field here. These policies are right for Europe and the world in general, but in other regions not very much is actually happening. Other countries' financial industries say they will take action, but there is no political or regulatory pressure to do so.

A Central Bank official described how the NGFS has founding members from the global south such as Morocco and Mexico, along with China, and suggested that there is some movement here. Europe can develop benchmarks and tools that other countries and regions can use. Europe should never forget that many of the countries impacted by climate change are beyond its borders.

### 5. Policy priorities: improving the taxonomy, managing the contribution of rating agencies, designing forward looking risk assessment tools and reshaping climate risk management

A regulator considered it essential to improve the taxonomy going forward. The EBA will issue a consultation paper at the end of the year, in which it will provide more detailed taxonomies for assessing risks and suggestions for how to measure these risks. These assessments must be built into banks' risk monitoring and implemented into adequate risk measurement models. These models will be difficult to create, and they will be necessarily imprecise and heterogeneous across the industry. However, the industry must experiment. Only experimentation, further work and a strong institutional culture will produce progress. The industry will have to change how it measures and assesses these risks. This assessment will not be based on historical information, because there is no historical information. The industry will have to produce markers, perform scenario analysis and possibly utilise counterfactual analysis.

An industry representative noted that there is an academic debate over whether ESG issues are a return factor or a risk factor, but their firm considers ESG in terms of what is possible to predict. When measuring ESG, it is important to consider what a company is doing in the future, what their rating is, and whether the overall ESG rating covers each of E, S and G. The 'G' is simple to measure, but the 'E' and 'S' are more complicated. This type of assessment will be more successful than trying to prove that sustainable companies are a better investment over time. The industry representative disagreed with his fellow panellists, suggesting that the numerical proof of this is not yet '100% there'. However, during the COVID crisis, companies with high ESG exposures performed better than companies with lower ones.

An industry representative highlighted the importance of data. There should be a sustainability report which defines data standards. Market participants are already doing this in different ways. It is often possible to find proxy measures for many metrics. The industry representative suggested that it is better to develop a standard using reliable historic data than to predict the future. The industry representative concluded his remarks with a note of caution: the rating agencies are an oligopoly, and there is considerable room to improve the scores they currently publish.

An industry speaker emphasised that it is essential for the financial industry to make forward looking projections rather than relying on historical data. Where possible, these results must flow into policymaking. These data points will be extremely relevant in areas like building resilience.

### 6. Europe should not wait for the world to catch up

An industry representative highlighted the importance of global acceptance, noting that Europe should not wait for the rest of the world to catch up. If Europe waits for the rest of the world, it will achieve nothing. The industry representative noted that the European UCITS product is one of the best products available around the world and suggested that the European financial industry should be ambitious and set a similarly high standard for ESG products.

A Central Bank official considered the global nature of climate risk highly significant. If Europe wants to maintain free trade, open markets and the movement of capital, it must also protect openness.

### 7. Ongoing work in the EU: developing a climate related vulnerability assessment and mitigation tools for banks

A regulator described the EBA's active engagement with a subset of volunteer banks to test their climate vulnerabilities. This is a way for the EBA to understand how banks are thinking about climate risk, how they are measuring it and what horizons they have in their operational timeframes. There was a positive response in terms of volunteer banks. Although the EBA expected the COVID would cause a number of these banks to withdraw, in fact they continue to be very engaged. The regulator outlined the EBA's priorities: to ensure climate risk is embedded in the culture of banks and to enhance risk measurement and disclosure within banks. The EBA will produce guidelines on pillar 3 disclosure for banks in terms of climate risk. This will entail broader guidance rather than being excessively prescriptive on the issues that banks should disclose. Additionally, as better risk management develops, the EBA will be able to consider prudential requirements or prudential measures.

### 8. Redirecting capital flows to sustainable investments requires further client engagement

A regulator outlined the aim of the sustainable finance agenda of the European Commission: to ensure the adequate refinancing of capital and the redirection of capital flows towards sustainable investments. This will ensure the industry manages the financial risk of the green transition properly and fosters transparency around disclosure on the industry's progress. The financial industry must enhance its disclosure.

An industry representative described how their firm has realised that corporates with strong ESG scores have suffered fewer financial losses in the COVID crisis, which means they have outperformed. There is increasingly more evidence of the correlation between ESG factors and financial performance. The industry representative's firm gathers data on the ESG KPIs of corporates on a forward looking basis. The industry representative emphasised that climate change will be even more important after COVID. It is important to increase more investor awareness about climate issues. Only when investors have a greater understanding of the importance of these criteria can they make fully informed investment decisions.

An industry representative highlighted the fact that for the UK public authorities it is now standard to have carbon emission scores for portfolios, suggesting that the use of these standards is working well.

An industry speaker reiterated the important role of data and queried how the industry could access the data it requires. The industry needs a clear dataset on climate risk, but it currently does not have one. Financial market participants believe that the disclosure regulation which comes into force in March 2021 is not workable at this point of time because there is no data, though these data points should be held within banks. The industry speaker stressed that the banks would need time to solve this issue.

An industry speaker described how one positive effect of the COVID crisis is that almost all banks have learned about the strengths and weaknesses of their business models. Some of the weaknesses in the sector concern the composition of portfolios. The industries most impacted by COVID 19 are passenger transportation, hospitality, entertainment and media, and non food retail businesses, many of which are not as green as was generally suspected. From a practical standpoint, next steps are that banks classify their customers into clients affected by climate change and clients responsible for climate change. Depending on the classification banks' risk management analyse risk margins and the composition of their portfolios. Banks must then consider whether to remove some of these clients because they are too risky. The industry speaker opined that banks should discuss sustainability and climate risks with them and seek to persuade clients to improve their energy mix, as one example. The industry speaker suggested that banks could even impose performance targets on clients and then remove them as clients if they do not adhere to these.

An industry representative stressed the importance of understanding the appropriate combination of actions needed from NGOs, financial regulators and supervisors. Establishing government guidelines and sharing best practice within forums like Eurofi contributes greatly to accelerating the financial sector's actions to tackle climate change. However, it is also critically important for financial institutions to engage with their clients and share perspectives on climate risk. The industry representative described how their firm shared a report with its clients on the recent Climate Financial Risk Forum guidelines on disclosures, risk management and stress testing.

An industry representative suggested that the COVID crisis had produced a greater awareness of the emerging risks on top of climate change and COVID. The industry representative is relaxed about the prospect of finding adequate ways to measure emerging risks from a risk management perspective. However, financial institutions must engage on risk management. It would be easy for lenders to unilaterally declare that they will not support a particular sector or country, but this could lead to 'sudden death' for these sectors or countries, which is not ultimately productive. The industry representative considered engagement with clients preferable to simple divestment, given an appropriate transition framework. This framework will require consensus among financial institutions and non financial institutions in both the private and public sectors. The industry should engage with all stakeholders and develop a consensus around a timeframe, the issues to be addressed and the initiatives to be taken forward, that reflect the particular situation of each country and region.

A Central Bank official queried whether this idea of consensus might delay progress on tackling climate risk. The industry representative clarified that the financial industry should not postpone tackling climate risk. As a lender, the industry representative's firm requires some form of industry consensus in order to make progress on this issue.

An industry representative emphasised that the opportunity to take action on climate risk is now. Europe will need to rebuild after this economic crisis. It is essential to rebuild in a better, greener and more resilient way. Europe is also at a historic turning point. As of 1 January, the EU27 can speed up integration and therefore implement a recovery plan and a green deal more quickly. Finally, it is essential for the asset management industry to collaborate with the public sector on investment opportunities through, for example, the EIB FC projects, which are now also applying sustainable finance principles. ■