CLIMATE RISK IMPLICATIONS FOR THE EU FINANCIAL SECTOR

1. Addressing the climate-related risk

1.1 Developing the new risk managements metrics and practices needed to assess climate related risk will take time

A regulator commented that there is a broad agreement on two things in climate risk: firstly, it has far-reaching consequences, much will depend in the long term on what we do in the short-term, and it affects very directly financial firms. While it does not originate with financial firms, they should not underestimate their impact on what they do for them and for society at large. Secondly, the traditional risk metrics are not sufficient. Data gaps are huge. Without better disclosure of the "known knowns" and "known unknowns" using a common language, little can be said about risks and transition. And the more we wait the more costly.

A Central Bank official stated that there are many challenges. There is huge uncertainty related to the size and timing of these risks stemming from climate change, meaning that the historical data is of very little use. The work has barely scratched the surface of really understanding how climate risks drive the uncertainty of traditional financial institutions. Physical risk and transition risk tend to be spoken of in one sentence, whereas there is a huge difference in how they affect financial institutions and what data is needed to address these risks. It is very hard to estimate when there will be tipping points in consumer behaviour, political behaviour or technological breakthroughs. Europe needs to work on a forward looking strategy.

An official noted that while climate risk drivers are relatively new in the risk landscape, they can be adequately captured by traditional financial risk categories. Since for a bank, climate ultimately translates into credit, market, liquidity risk, or operational risk. Considerable work remains to be done to translate this theory into practice. Climate is an extremely long-dated risk and that makes measurement challenging. A globally agreed taxonomy is necessary and more data is needed to make existing regulatory and supervisory frameworks work well.

An industry representative commented that existing metrics need to be used, because at the end of the day it is financial risk. There are also challenges specific to climate change, such as the time horizon. With climate, there is much more emphasis on understanding where business is being done and the location of the underlying asset for an investment or a loan. There is a very long way to go when it comes to physical risk. Working with historical data only gives a distorted image of what the future holds, because the physical impacts of climate change are going to be different and beyond anything that was expected in the past. In Europe there are less frequent extreme weather events, but the problem is that the models are not set up to capture that kind of existential risk. The models are better suited to capturing incremental changes, but the type of potential dramatic changes that are in the system are not necessarily easy to represent in the form and the type of models that are currently used.

An industry representative stated that there needs to be an acknowledgement that society is at the beginning of the journey in terms of modelling and understanding such risks. The same is true when looking at net zero carbon, not just physical risk. The technological changes that are required for moving away from fossil fuels entirely, are a little bit beyond what the models can currently capture.

1.2 Investors as well as insurance companies share the same priorities; but commonly agreed concepts and definitions are needed to access adequate and reliable information

An industry representative commented that this is as much an opportunity as a risk. It depends on what type of insurer someone is and whether they are a life insurer or general insurer, looking at the two sides of the balance sheet. It is important to really understand the transition risks and what is going on in the real economy. The disclosure and getting hold of this data is very important, but the problem is the lack of standards. It is difficult to tell who is greenwashing and who is really acting. Recent reports from the CA 100+ and the Transition Pathway Initiative show that fewer than 10% of the total companies are getting anything right.

An industry representative stated that there are plenty of initiatives in the private and public sectors, but no commonly agreed definitions, concepts, or expectations and this makes it hard for firms and authorities to perform an in depth assessment of the current situation and draw meaningful comparisons. Certain players will get attached to what they have been doing so far, while others may prefer to wait and see. Europe is far from having a very precise understanding of environmental, social and governance (ESG) physical and transitional risks from a whole-firm perspective, let alone from a system perspective. This is mainly because the information is difficult to obtain. If Europe was to get there it would also be necessary to complement that with a more forward looking approach in terms of transition risks.

A Central Bank official noted that national banks tend to be frontrunners in the fight against climate change, but the road ahead is challenging. The approach focuses on three main priorities: data and disclosures; risk management; and governance and strategy. The previous place had been one of no taxonomies or regulatory approach, but Europe is now starting to have a common language. It is time to stabilise the referential that everyone uses, so everyone can use the same language and use comparable concepts. It is not just for banks to steer transition for the broader economy.

An official (agreed that something is needed that is globally harmonised. Currently the contents of the information vary, depending on where the reader sits and what system they are under. Data is needed.

1.3 Data credibility requires addressing an unprecedented complexity

An official agreed regarding “the known unknowns”. There are a number of data gaps and the market is starting to meet them. If companies can help banks adjust existing risk management tools and measurement methodologies by incorporating the knowledge that organisations bring, it will go a long way to bringing the kind of data that is needed. There is some talk about whether the risk weights need to be changed, to reflect climate risk. Banks are now making some of those decisions on their own.

An official noted that 10 or 15 years ago it was possible to see insurance industry companies focusing on their internal ecological footprint, as if they were trying to show the world that they were responsible. However, in the last three or five years there has been an explosion in ambition. Modelling risks are seen, the investment side is seen, and a number of tools are seen to measure and represent the risks. It is very hard to predict the future. One way of calculating the risk, as well as the transition risk, is working with scenario analysis.

An official wondered if companies have recently moved on that. When looking at what climate means from a net zero, forward-looking perspective, it is a completely different approach and a very demanding one.

An industry representative agreed that it becomes incredibly complex. Their organisation has committed to provide hundreds of billions of dollars in sustainable financing for the next 10 years. The devil is in the detail of how to count against those hundreds of billions of dollars. Biodiversity is potentially a dimension that is even more complex than climate, but the whole point is to help the clients transition. It is important that there are no other players that are less scrupulous and end up financing the same businesses that banks are exiting from and reaping the profit.

With respect to ESG data, the drive toward standardisation should not end in excessive simplicity. It is incredibly complex, and the method is difficult. Standards are needed regarding data, but they need to reflect the complexity in a scientific way.

1.4 Structuring an appropriate transition path for economies requires further collaboration between financial institutions, corporates, and public authorities

An industry representative stated that climate risk is the defining risk management challenge and a strategic opportunity for any financial institution that is operating within the EU. Everything should focus on the endgame about how to get emissions down to “Net Zero” in order to reach a 1.5-degree world in 2050. Financial institutions have a really important role in achieving that. The first step is to start the journey. Companies need to examine the conditions for an effective climate risk management, looking at clients, communities, culture, calculations, controls, conduct, contracts, and communication.

An industry representative noted that one aspect that has not been deeply touched upon is client engagement. The industry representative’s company has developed a client energy transition framework, and started with three sectors: oil and gas, coal mining, and utilities power generation. It will gradually phase out lending to clients unaware of ESG, comprising approximately 10% of exposures. It is not just a banking job; it is a collaboration with the client, but it is also a collaboration with governments and policies. Sometimes clients are faced with a conundrum, which is whether to continue to do traditional business, which is very profitable, or invest in a less profitable and less certain type of renewable business that is still in start up mode. Government policy should also keep pace with the direction of travel.

An industry representative stated that their company works with banks, investors, and insurance organisations that are looking to improve their risk management processes and prepare for these incoming regulations. There are significant variations in the market in terms of the depth of reporting, analysis, and awareness. Those variations can even be seen between regions. There are differences between small and large institutions; that is very important because smaller institutions are certainly not as far along in the process.

1.5 Although developing views in the very long term is a challenge, climate-related risk is also an opportunity for the insurance sector to leverages existing knowhow

An official agreed with much of what has been said, as their expertise is insurance and pensions. While the investment side is interesting, what is special for insurance is that climate risks and sustainability are not just the concept of an operational risk or of transforming into liquidity. They are also areas for opportunity. The dialogue is a developing area, but the insurance industry was way ahead of the regulators to begin with.

An industry representative explained that on the underwriting side it is about how to link climate risks with the financial risks, and whether they are market risk, credit risk or operational risk. In insurance there are other risks in pricing and reserving risks, and natural catastrophe risk modelling, which is very well understood. The challenge is how to apply those metrics to transition risks and physical risks. That is very complex in the detail, with simulations of climate over very long periods into the future. The industry representative’s organisation has already started to offer its clients services about that, helping them understand the impact of physical changes in the climate that might impact their physical assets such as their factories and supply chains. The aim is to help people understand the transition and communicate that in a standardised way to investors.

2. ESG and climate related challenges

2.1 Supervisors at national, regional, and global levels are addressing ESG challenges, which require however strong political commitment and support

A regulator noted that the European Banking Authority (EBA) has been mandated by the Commission to take a deep look at three things: ESG risk management and

supervision in the EU; realistic methodologies to assess the alignment of banks and investment firms with the EU taxonomy; and the key features of a harmonised disclosure framework for these firms. In May it will release the conclusions of a pilot exercise carried out with 28 banks from 10 EU countries which will shed light on what can currently be said of the carbon footprint of some of their non-SME portfolios using different approaches.

An official explained that the Basel Committee's public version of its workplan was scheduled to be released that week. The Committee's work programme over the coming years has placed climate risk high on the list. A dedicated taskforce on climate risk was set up in 2019, co-chaired by Frank Elderson, from the ECB and Kevin Stiroh, who leads the Federal Reserve supervisory work related to climate change. Two analytical reports have been produced, which explore how climate risk drivers arise and impact both banks and the banking system at large, and the current practices that banks and supervisors use to measure climate-related risks.

An industry representative observed that there is a great deal of piloting going on in the market, especially from larger institutions. It is important to have the right balance between the push to raise the bar that is coming from all the regulatory agencies and governments and leaving flexibility. That flexibility is what enables everyone to understand how far they can go.

An industry representative noted that to be successful in this enterprise it cannot just be the financial services sector that applies the pressure; it also has to be government, with democratic acceptance of the decisions that governments make. Companies have to work closely with people to help them make the transition and to understand what the different pathways are.

An industry representative stated that when thinking about the 'S' of ESG there are significant transition risks that are faced, even in Europe. One example is the coal sector and the massive challenge that will place on the economies of Poland, the Czech Republic, and Germany as they transition out of a coal based economy. Insurance companies provide a great deal of support through helping manage employee risk, but also with managing the pension risk through the life insurance sector. Companies must work in concert with covenants to work on the societal risks, the transition risks and the adaptation.

2.2 Other ESG areas such as loss of biodiversity, deforestation and water scarcity show many similarities in terms of stakes and risk to climate-related ones

A Central Bank official commented that climate was the first issue on their agenda, but what goes for climate will also probably go for other environmental developments. A report issued last year signalled the loss of biodiversity. There was a vast decline in ecosystem services, and therefore it is reasonable to argue that this decline will have a similar effect on the real economy. The same is true for water scarcity and deforestation. It is important to include all of society to make it a just transition, as well as asking what role a central bank and supervisor can play in that regard. People tend to enter an atmosphere of political sensitivities around things that are mostly relied on by governments or that governments are initially responsible for.

A regulator stated that the mandate is ESG. The regulator's organisation has been focusing its efforts far much more on the 'E' of ESG than on the other initials because that is the area where urgent work needs to be done. There is a complex issue in terms of getting the data and the risk management tools right. If the framework is not sufficiently well accepted and harmonised, then there is a great risk that firms will jump the gun to some extent under the pressure of investors and different groups. It is important that firms, investors, and customers should be in a good position to assess not only what the situation is now and what is known about it, but also what it has a hard time knowing about it.

An industry representative stated that carbon pricing would help address ESG, but it has a subset. There is a need to have greater price and data transparency across everything. It does not just concern emissions and carbon pricing; it concerns natural capital and how to put a proper value on price. There cannot be healthy banks unless there are healthy economies, and there cannot be healthy economies unless there are healthy societies. Society does not have room for Basel III or Basel IV when it comes to the climate.

3. The top priorities of the panel

Panellists stated that their top priorities are temperature alignment, disclosure, a uniform standard, roadmaps, adaptation, not to overshoot the 1.5-degree temperature increase, and carbon markets.