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Climate and sustainability risks: implications in the banking sector

Thank you so much and thanks for having me. I am sorry I was not able to be there in person. Climate change has made the news all over the summer again: wildfires and heatwaves in Greece, Turkey and California and hurricanes, storms and floods in Germany, Belgium, New Jersey and Louisiana. The urgency to prevent further climate change is rising on corporate and regulatory agendas. Ahead of COP26 in November, over 50 banks, representing US$37 trillion, the equivalent of almost a quarter of global banking assets, have committed to aligning their lending and investment portfolios with net zero emissions by 2050. These commitments constitute a momentous challenge for banks, but also an opportunity to lower their exposure to climate risk and develop new products. The risks related to the transition to a net zero economy are generally well-understood, although the scale of expected impact varies wildly under different scenarios.

In the best-case scenario, where an orderly transition takes place, supported by rapid technological progress and strong political alignment, banks can expect to see moderate impact of some stranded assets in the fossil fuel industry, higher operational or capital expense and possibly higher energy prices. All of these could lead to corporate asset devaluations or lower profitability and an increasing probability of default of some borrowers. In a scenario where disorderly transition takes place, hampered by lack of political alignment and slow technological progress, the same risks grow exponentially. A corporation could be ill prepared, fail to invest in technology or fail to adjust business models, leading to widespread devaluation, bankruptcy, shock on the economy and lower wealth across the board − a potential climate Minsky Moment.

However, the worst-case scenario is a failure to deliver on the net zero targets all together. Economic models provide but a pale image of the economic cost and the risks to the financial system that may arise because of the physical impact of climate change. The continued increase of temperature rises will drive water and food shortages, extensive flooding, biodiversity loss, conflicts and mass migration, all of which can cause disruption to society, to the economy, and create unmanageable risks for banks.

In this context, net zero commitments emerge as sound net zero risk management policy to present the worst impacts of climate change and protect the balance sheet. Indeed, banks are highly exposed to climate risk but they also hold important levers to lower the risk for themselves, for their clients and society at large. How can banks deliver on this net zero commitment? They are faced with the collective challenge of understanding whether and how their clients are reducing greenhouse gas emissions at a base that is aligned with the urgency and the scale of the problem. Firstly, proper accounting and disclosure of greenhouse gas emissions is critical. Asking clients as a matter of business to report emissions when they apply or renew their line of credit, would help build a much more precise picture of portfolio emissions and transmission capacity in a portfolio. Many smaller companies in their client book may need help in understanding what is expected of them and what technical and market solutions may be available to help reduce emissions, and banks can provide guidance and pointers for these clients.

However, where banks' roles are the most important is in financing the transition. Corporations will need to retro-fit their production facilities to decommission high-emitting assets. They will have to invest in energy efficiency or renewables. SMEs and households can be incentivised with preferential conditions on mortgages, for efficient cars, houses or low interest loans for retrofits. A number of banks have started piloting those mechanisms. Now is the time for the industry to share lessons on what financial products are most effective at reducing emissions so that these problems can be scaled and become embedded into regular lending practices. Banks can nourish their role as key intermediaries to become a driving force in supporting the decarbonisation of the economy. This will lower their individual and collective exposure, create opportunities for new financial products and services, and support a more liveable planet for all of us. Thank you.