

# Sustainability risks in the financial sector

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## 1. Addressing physical and transitional risks: the imperative for holistic and forward-looking approaches

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The Chair highlighted that the financial landscape faces significant physical risks associated with climate change which have materialised rapidly through extreme weather events. These occurrences lead to property damage, operational disruptions and considerable financial losses globally, thereby posing significant risks to the financial sector.

Recent assessments released by the Network for Greening the Financial System (NGFS) provide significant insights into these challenges. Critical milestones are assessed at 2050 and 2100, and projections suggest that if current policies persist, there could be a loss of approximately 15 percentage points of GDP by 2050. Conversely, adherence to the objectives of the Paris Agreement could limit losses to around 7.5 percentage points of GDP by 2050.

While sustainable investment is on the rise, this growth remains inadequate to sufficiently address the extensive challenges faced by the financial sector.

### 1.1 Strengthening environmental, social and governance (ESG) adoption

An industry representative remarked that the realities of rising temperatures and shifting weather patterns unequivocally present significant financial risks that extend beyond mere environmental concerns. Financial institutions recalibrate strategies to manage these risks effectively while seizing sustainable opportunities arising from the changes. This proactive engagement entails integrating ESG criteria comprehensively into operational frameworks.

Motivations behind this integration aim to mitigate risks while identifying sustainable lending opportunities essential for long-term growth within an evolving financial environment. Institutional commitment to ESG strategies seeks to confront pressing global climate challenges while accurately measuring associated climate risks. The financial sector has witnessed substantial progress in adopting ESG strategies in recent years. Increasingly, the sector embraces its responsibilities and recognises the importance of fully engaging with sustainability issues.

Institutions prioritise the identification of both physical and transitional risks within their operations. Institutions employ various tools, including carbon emission forecasting models and commitments to carbon neutrality, but it is quite a challenge. There is also strong pressure from the regulator to focus on all these risks and not so much on the impact.

### 1.2 Embedding sustainability risks into traditional credit risk frameworks

An industry representative emphasised that integrating sustainability risks into traditional risk assessments has become crucial. Banks increasingly recognise the necessity of factoring in ESG criteria within existing frameworks while evaluating credit risk. This was the common message from the 2021 BCBS paper on the climate-related risk drivers and their transmission channels and the 2025 NGFS paper on the conceptual framework for nature-related financial risks. A critical focus centres on how sustainability risks impact creditworthiness. Discussions arise surrounding the potential need for adjustments to borrowers' classifications within internal rating systems.

Evaluations predominantly rely both on historical quantitative data and qualitative assessments to take into account the information not included in the historical observations. The need for qualitative assessment seems to be underappreciated.

### 1.3 Enhancing insurance models to tackle both attritional and catastrophic climate losses

An industry representative remarked that the insurance industry faces an increasingly intricate landscape demanding advanced methodologies for effective risk assessment. Traditional models must adapt to meet the complexities of the rapidly evolving environmental context. Insurers need to consider both natural hazards and human-induced factors, exemplified by pressures from outdated urban drainage systems. Ongoing trends toward higher urban density raise overall vulnerability, significantly increasing asset loss potential.

Inflationary pressures have further complicated predictions, resulting in elevated repair costs that insurance organisations must contend with. It is recognised that historical data alone will not suffice for predicting future risks. Increased attention must also be directed towards attritional losses, which are frequently overlooked compared to extreme events. Insurers must acknowledge that smaller losses possess the potential to substantially impact the industry.

Generali is undertaking a multi-faceted approach to enhance risk management capabilities. Collaboration with leading academic institutions strengthens capacities for climate modelling. By leveraging advancements in satellite technology and AI, Generali is improving its data analytics capabilities. Evolving products reflect shifting risk landscapes, and dynamic pricing adjustments mirror the outcomes of ongoing risk assessments. Collaborative efforts among stakeholders pave the way for meaningful change in an evolving regulatory landscape.

## 2. Overcoming data and measurement challenges: towards reliable and actionable ESG information

### 2.1 Promoting standardisation and relevance through the Corporate Sustainability Reporting Directive (CSRD)

An industry representative highlighted Omnibus as the biggest policy issue, while CSRD represents a major advancement in streamlining ESG data. CSRD helps shift the burden of data gathering from financial services to corporates and ensures comparability and quantification for investors.

While the CSRD may have overreached, approximately 300 data points are truly relevant under CSRD, and just 20 are necessary under the taxonomy framework. Reducing the number of companies under the directive's scope could negatively affect SME access to funding and the broader availability of ESG data. Investors need access to this data across the board. A lighter, phased approach could delay assurance requirements, while maintaining a base level of reporting from SMEs.

### 2.2 Developing qualitative and forward-looking risk assessments amidst data gaps

An industry representative emphasised that evaluations predominantly rely on qualitative assessments as comprehensive data predicting the future may not always be readily available. Qualitative approaches become paramount in forward-looking risk analyses, particularly in evaluating borrower resilience against evolving conditions. Additional risk factors require consideration, particularly those linked to natural disasters, such as earthquakes and tsunamis especially in some jurisdictions. These risks may present more significant threats to certain borrowers compared to broader climate change risks and thus necessitates a thoughtful examination of various risk types and their anticipated future implications.

This moment presents an opportunity for all institutions to reconsider priorities, contextualise sustainability risks and implement essential qualitative adjustments necessary for effective risk management. Despite ongoing challenges, implementing a proactive and holistic approach will fortify existing risk frameworks against potential disruptions.

A central bank official remarked that the Bank of Japan does not have enough information on how carbon pricing affects revenue, nor on how capex on greening investment affects financial soundness. However, by comparing the results provided by banks, and using a bottom-up approach, it can gain some sense of what is going on. The Bank of Japan actually provides this feedback to participating banks, and in providing the feedback there is an opportunity to improve scenario analysis and then improve the existing risk management framework, promoting collaboration between private and public sectors.

### 2.3 Leveraging technology and academic partnerships to advance climate modelling

An industry representative explained that Generali collaborates with leading academic institutions, such as the Massachusetts Institute of Technology (MIT) and the University of Trieste, to strengthen climate modelling capabilities. Advancements in satellite technology and AI are leveraged to improve data analytics capabilities.

Fostering awareness through targeted educational campaigns for small-and medium-sized enterprises forms a fundamental component of Generali's strategy. Such initiatives are vital for enhancing climate preparedness across the client base. Developing comprehensive frameworks ensures the effective management of claims, thereby solidifying organisational defences against changing market environments.

## 3. Regulatory frameworks and market practices: ensuring credibility, coherence and predictability

### 3.1 Strengthening supervisory practices through international cooperation

A supervisory representative outlined that the IAIS has maintained a strong focus on addressing sustainability risks, with a considerable emphasis on climate-related challenges. Approval of the IAIS' application paper on supervision of climate-related risks in the insurance sector reinforces the organisation's continued commitment.

Extensive collaborative efforts among supervisors across the globe culminated in a commitment to clarifying effective approaches to integrate sustainability risks into supervisory frameworks.

The IAIS prioritises climate risk management, given that this can impact both the asset and liability sides of insurer balance sheets. International cooperation through global supervisory bodies is crucial, while multi-stakeholder cooperation is essential to deliver meaningful progress on climate-related risk management.

### 3.2 Supporting predictable and incentive-based policy frameworks for effective transition management

An industry representative remarked that proper incentives, particularly internalising environment-related externalities through taxation, are key. Continuity and predictability of policy are crucial. There needs to be a realisation that the financial services sector is not going to lead that process, and instead it will follow and support the real economy in moving. The focus should be on moving the economy to where it should be. Financial institutions should see themselves as policy takers rather than policy makers. A risk-based rather than a climate-centric approach is preferable.

### 3.3 Balancing ESG ambitions with economic viability and strategic resilience

An industry representative outlined that ESG strategies must be realistic, economically viable and responsive to market dynamics. Mitigation is as important as adaptation or loss prevention. Generali builds ESG strategies, balancing decarbonisation goals with sound asset allocation.

Generali also builds an ESG strategy that tries to adapt to the market conditions, defining asset allocation to account for both return and decarbonisation targets and also avoiding a concentration of physical and transitional risks. The ESG agenda is inherently inflationary, requiring policy support to make green investments financially attractive. There are three areas requiring targeted policy support: scaling mature technologies, expanding newer technology and funding R&D. Punitive regulations are counterproductive; targeted policy support is necessary.

## 4. Enhancing public-private collaboration: building a common understanding of climate risks

### 4.1 Facilitating bottom-up scenario analyses to improve risk management and develop platforms to share insights and best practices

A central bank official remarked that the Bank of Japan is using a bottom-up scenario analysis approach, in contrast to the EU's top-down Fit for 55 model, to gather detailed feedback and data from banks. Intensive discussions with banks help shed light on important operational issues. International platforms like energy fairs are a good place to share insights.

### 4.2 Empowering joint efforts to bridge protection gaps and foster resilience

An industry representative outlined that services, like alert or adaptation, support through the value chain. Generali then has its monitoring of portfolios, accumulation, limits in the risk appetite framework, and increasing the penetration to better diversify the portfolio and transfer the loss. The ECB and the European Insurance and Occupational Pensions Authority (EIOPA) did well with the latest paper, which has two legs. The loss prevention part has a very good effect because it is reducing the expected loss, making it more affordable, but it is coupled with promoting local resilience. Without that, the problem will not be solved.

A supervisory representative highlighted that the IAIS emphasises the need for public disclosure of material risks. Market conduct risks, such as greenwashing, require vigilant supervisory frameworks. The IAIS work also considers "outward" risks from the insurance sector to the broader financial system that supervisors need to monitor – specifically, whether insurance protection gaps arising from the increased frequency and severity of natural catastrophe events could spill over to, for example, the banking sector by impacting credit risk of commercial and residential property loan portfolios.