

Sustainability risk in a fragmenting world

1. Climate risk management practices are maturing

1.1 From inflated expectations to pragmatic financial risk management

The Chair that the concept of leadership on the financial sector has been evolving significantly. The purpose of the session is to explore how climate risk management has evolved and how this evolving focus manifests in banks, insurance companies and investors.

An industry speaker noted that recent progress on climate risk management has been driven by 'friendly' regulatory pressure from the ECB. European banks face many different important policy challenges and priorities, such as defence or digital payments. In the coming years, it may not be possible to improve climate risk management practices at the same pace of the last few years. Ultimately, the need to address climate risk should not be used to block progress on other policy priorities. The money and effort spent on defence will protect Europe's values, one of which is the sustainable management of climate risk.

An industry representative remarked that financial institutions are managing climate risk in increasing sophisticated ways. Until recently, the attention and effort were on net zero, transition and decarbonisation, but there has now been a shift to physical risk. Some of MSCI's recent work indicates that the market is starting to price in physical risk.

1.2 The focus for supervisors is governance

A central bank official acknowledged the progress made by the European banking sector in integrating climate and nature risk. The foundations have been laid to enable the banking sector to prepare for and react to climate and nature risk. The ECB's role is to ensure that banks identify and manage climate and nature risks. It does not want to influence lending decisions. As a supervisor, the ECB should not tell banks where and to whom to lend. Supervisors are not responsible for setting climate targets. Treaties, laws and regulations should set targets. In view of the rising and exponential nature of climate risks, it is good practice for institutions to define their own risk appetites. Transition planning and stress testing can help institutions operationalise their risk appetites, but supervisors should not set these targets for financial institutions.

An official stated that the IAIS has opted against introducing new rules for climate supervision. In 2021, the IAIS concluded that there was no need for a complete rewrite of the existing Insurance Core Principles (ICPs). However, it was clear that certain elements needed to be made more explicit. The IAIS added explanatory text into

the introduction of the ICPs to explain that they cover traditional risk and emerging risks - including climate related risks specifically. In 2025, the IAIS issued an application paper to support practical implementation, promoting peer exchange, consistency between approaches and cross jurisdictional learning on the principles and standards. The paper outlines how supervisors should approach climate related risk and provides examples to guide supervisors in applying these principles and standards in their jurisdictions.

1.3 Practical steps to reduce fragmentation in insurance supervision on climate

An official explained that the IAIS has been collecting data on climate related risks for several years in order to understand how the insurance sector is exposed to climate related risks and create a global baseline for data. IAIS members are beginning to use this information to adapt their own national reporting requirements. The aim of this endeavour is to increase regulatory convergence and reduce the regulatory burden. Another practical example to reduce fragmentation is by encouraging greater collaboration between supervisory colleges on the impact of climate related risks.

1.4 Progress is a result of selective de-risking rather than systemic change

A central bank official noted that the banking sector appears to be ahead of the broader economy in implementing climate risk frameworks, but this is a consequence of selective de-risking.

2. Bridging the protection gap requires mutualisation and national public-private schemes

2.1 Risk-based insurance incentivises demutualisation, but society needs mutualisation

An industry representative highlighted that risk-based approaches push insurers towards 'demutualisation' to remain profitable, but the escalating nature of climate events demands even greater 'mutualisation'. It is important to remember that Europe's insurance gap is huge: only 25% of assets are protected against climate events.

2.2 Climate insurance schemes can be effective at national level

An industry representative explained that state mandated insurance coverage offers one potential solution, citing France's Régime d'Indemnisation des Catastrophes Naturelles (CatNat), Romania's Pool ul de Asigurare împotriva Dezastrelor Naturale (PAID) and Italy's 2025

law requiring businesses to insure against natural disasters. All these schemes are supported by global reinsurance. These examples of effective schemes demonstrate the potential of national models. This suggests that there is no need for an EU-level scheme, although the EU supervisory authorities could play a role in supervising national initiatives.

3. Data challenges threaten the operationalisation of climate risk frameworks

3.1 Complex and unstandardised data

An industry speaker stressed that the sector is now entering a phase where climate risk management measures are being operationalised. This transition has exposed major data-related challenges. There are four persistent issues with data. First, the data is overly complex. Secondly, there is a lack of standardisation across regulatory frameworks and voluntary frameworks such as the Science Based Targets initiative (SBTi). Thirdly, there is an absence of structured frameworks for certifying data. Finally, there is no public or shared infrastructure to help avoid overwhelming clients with the burden of repeated data requests.

A central bank official commented that the availability of data is a question of demand. If there is demand, supply will follow. To understand physical risk, the industry had to grapple with unfamiliar data sources. As these efforts have developed, more useful sources of data have emerged. The data remains patchy, but the overall quality should improve over time as the market crystallises.

A central bank official agreed that data is a difficult issue to address. The International Sustainability Standards Board (ISSB) is making progress on improving the quality of climate data. In the practice of climate risk management, it is essential to use science, be data driven and take a fact and risk based approach risk instead of following a particular political agenda.

3.2 Geospatial and asset-level data enhance visibility of systemic risks

An industry representative identified two key advances on climate data. First, there has been an improvement in modelling physical risk hazards. MSCI works with Swiss Re to cover 28 chronic and acute hazards. This work is focused on improving the loss estimates for each hazard to enable this data to be integrated into processes such as credit scoring. This type of data is not very useful without data on the exact location of an asset, its physical characteristics and how much of an entity's business value is tied to it. These factors are generally known for a single asset, but some clients are investing in tens of thousands of entities, each of which can have many different types of assets in different locations, each of which makes a different contribution to revenue, earnings and future cash flow. The second key advance is in the collection of asset level data. The development of new technologies has unlocked the collection of asset location

and characteristics data. MSCI now holds data on over 3 million assets tied to 700,000 companies. This geolocation type data can be used to analyse new and emerging risks. Geospatial asset data can be overlaid with physical climate hazards or with tariffs, conflicts or biodiversity and nature related risks, for example.

A central bank official added that the further development of counterparty level data will enable financial institutions to assess risk properly and ensure that supervisors can form an accurate view of the institution's risk position.

3.3 CSRD and ESRS must balance simplification with robustness

An industry speaker called for the creation of public infrastructure to ease the regulatory burden. An industry representative suggested that the Corporate Sustainability Reporting Directive (CSRD) and European Sustainability Reporting Standards (ESRS) are the first steps towards this kind of shared infrastructure for climate reporting.

A central bank official agreed that CSRD will play a key role in ensuring high quality data provision to market participants. However, reducing the scope and content of CSRD will not necessarily lead to a reduction in reporting burden. Financial market participants need data. A harmonised framework in which all market participants can access data may well be preferable to a fragmented market in which very different financial institutions need to ask the market for the same data many times.

3.4 The industry needs a lower regulatory burden and more granular data

An industry representative highlighted two key pain points in climate policy. First, investors are currently lacking both clarity and predictability. In many institutions, sustainable finance expertise is often being wasted on relabelling. Around €660 billions of funds have been relabelled over the last 15 months. This means there are fewer launches of new funds. Ultimately, financial institutions can choose to either spend time complying with regulations or allocating investments. Secondly, the data used for investments associated with the energy transition are far more granular, dynamic and forward looking than the data that are produced for regulatory reporting. This growing gap is something that policymakers should bear in mind. It is important to recognise that disclosure, while useful for investors, does not show the complete picture. The marginal information value of disclosure is much greater for smaller entities, for which there is almost no other data, compared to larger entities, for which there are many other data sources.

4. Tailored approaches for managing climate and nature related risks

4.1 The NGFS's new short-term scenarios reveal the price of inaction

A central bank official outlined the new short-term scenarios developed by the Network for Greening the

Financial System (NGFS), which are designed to align better with market horizons and supervisory needs. These scenarios are more granular than previous long-term models and include sectoral and geographic data. NGFS has given its users the key to understand the data that is used to create each scenario, which should allow them to adapt it to their needs. These short-term scenarios illustrate the price of inaction. A three-year delay in transition policies more than doubles the GDP loss from 0.5% to 1.3%. In the worst-case scenario, in which the physical risks combine and produce an additional effect, there could be a tremendous impact of up to 12% of GDP in Africa, 6% in Asia and 4% to 5% in Europe and the Americas.

These models are useful tools for institutions to use to analyse risk, but they must be adapted to the nature of an institution's geographical and sectoral exposures. The world's countries and continents will not be affected in the same way. There will be a much more severe impact on a Pacific island compared to a resilient country in Europe. The same analysis applies to sectoral exposures. There will be more significant impacts in the energy, transport and agriculture sectors. Equally, a financial institution will have to understand many factors that are not in the scenarios to develop an adequate action plan to mitigate climate related risks. For example, the NGFS's short term scenarios do not consider any rise in sea levels or tipping points. There are many other elements that are still not able to be modelled properly, and it is likely that some of these risks are significantly underestimated. If an institution is more exposed to risks that are not included in the NGFS scenarios, it becomes even more important to ensure that it adapts the scenarios and seeks to include additional data in its own analysis.

Ultimately, the world will need both adaptation and mitigation. Global temperatures are rising and there is a need to improve resilience in all economies. The advanced economies are relatively resilient, but the funding needs are significant in emerging market economies. It is worth remembering that the cost benefit of adaptation is positive. Each €1 invested in an adaptation project can produce between €2 and €15 in economic benefit.

4.2 Balancing biodiversity and transition goals requires a holistic perspective

An industry speaker emphasised that addressing climate change and conserving natural capital and biodiversity

entails a complex set of trade offs. This complexity needs to be managed financially and non financially. It is crucial to understand the totality of nature and climate effects in a particular area. When considering activities in the food or agriculture sector, it is important to understand the full value chain of a good from production to consumption. This is an important lesson from the efforts to integrate the work of the Task Force on Climate-Related Financial Disclosures (TCFD) and the Task Force on Nature-Related Financial Disclosures (TNFD). There are significant benefits to understanding climate risk in a holistic way, using a combined approach which incorporates the concrete effects on actual goods. This is particularly important in the food and energy sectors, which are the basis of stable societies. The banking sector would benefit from the development of further combined scenarios that consider nature and climate risks in an integrated way and a change in accounting practices to incorporate ideas such as nature based value recognition.

4.3 Green incentives

A central bank official noted that the use of both long-term and short-term stress testing can be useful in assessing client risk. In the case of the Hungarian National Bank, its long term stress testing has shown that a lack of alignment with climate targets could significantly increase credit risk in commercial real estate, agriculture, food production and tourism. While its short term stress testing exercise has demonstrated that the banking industry should remain solvent if the carbon price increases significantly, there will be increased credit risk in energy generation, public utilities and mining.

Indeed, demand is the key to the transition process. Good incentives can incentivise both the demand side and the supply side. In 2020, Hungary introduced green preferential capital requirements. Since the introduction of this policy the share of green exposures in the corporate segment has grown from below 1% to around 6%. These requirements enable institutions that invest in green exposures to access more credit and benefit from a lower cost of capital. Secondly, Hungary created a green housing programme in 2021-22. The Hungarian National Bank injected liquidity into the Hungarian economy by subsidising green housing. Thanks to this programme, the share of green collateral behind Hungarian mortgage loans has risen to 50%. Incentives can drive significant progress in the management of climate related risk.