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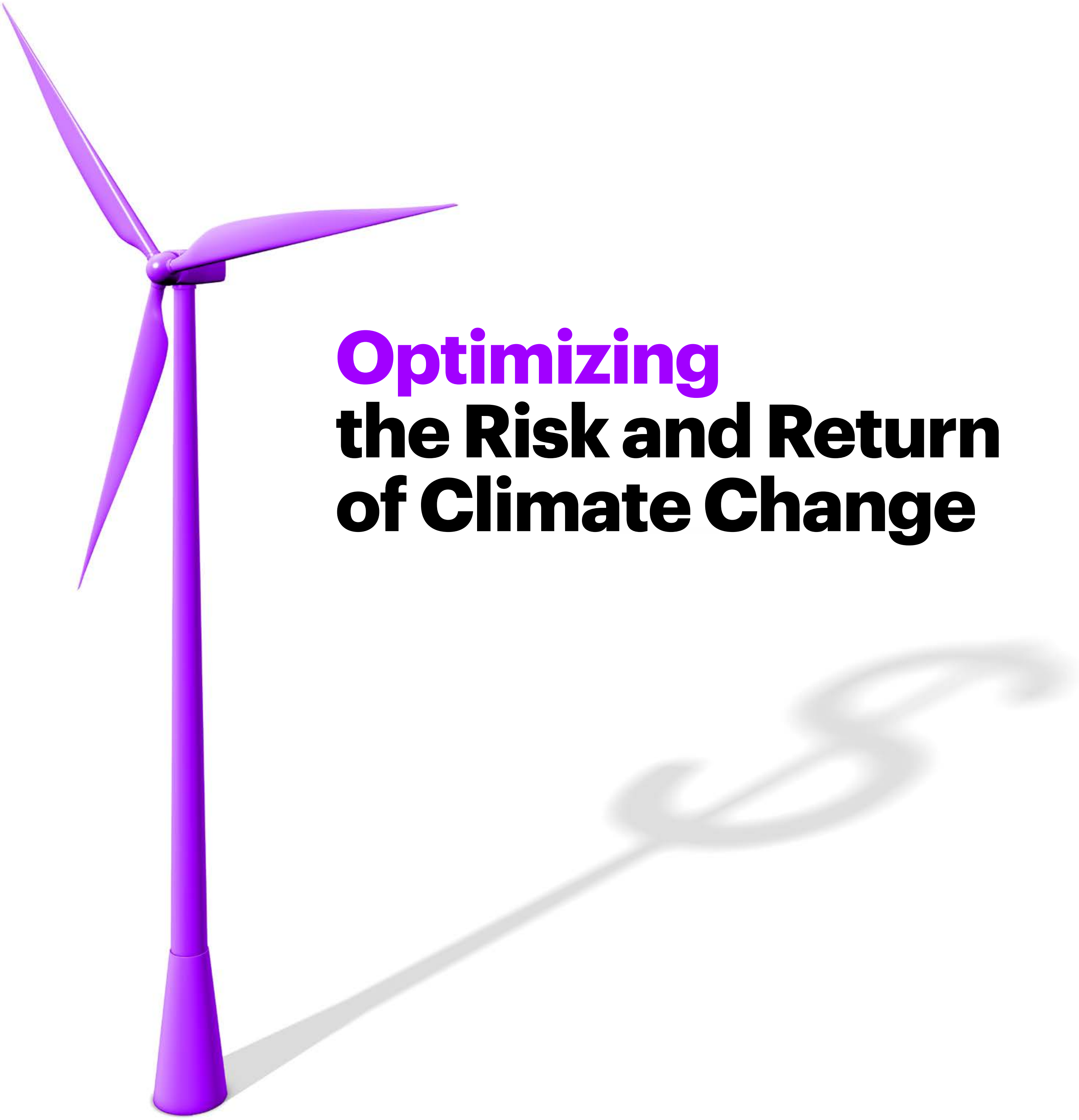


Optimizing the Risk and Return of Climate Change

Risk and Regulatory Implications for Banks

Executive summary

Mitigating climate change is not just an environmental responsibility—it is also an economic necessity. Rising sea levels and greater storm surges are expected to cost coastal urban areas over US$1 trillion each year by 2050.[1] The longer we delay meaningful mitigation, the greater the disruption due to climate change.

Governments globally are making concerted efforts to mitigate the impact of climate change. The 2015 Paris Agreement provides the overarching international framework for limiting future warming to no more than two degrees Celcius above the pre-industrial average.[2] Delivering this commitment is a significant undertaking. The Organisation for Economic Co-Operation and Development (OECD) estimates that US$6.9 trillion of investment would be required each year to 2030 to meet the Paris Agreement goals.[3] Government purses alone fall short: their development budgets to finance infrastructural shifts are unlikely to be enough to transition economies to the new low-carbon standards. Private finance should be mobilized—and banks called on to facilitate and safeguard this transition.

Given the huge sums of capital required and the exposures to climate risks already locked into financial markets, banks face significant financial and nonfinancial risks from both climate change itself (physical risks) and associated mitigation measures (transition risks). The very mix of banks' existing risk taxonomy—that is, what is considered credit risk, market risk, and operational risk—is set to be reconsidered.

On April 13, 2020, New Zealand became the first country to introduce a law that requires banks, insurers and investment firms to report the impacts of climate change on their business.[4]

Note: This is an updated version of a paper that was first published in September 2019 by Parker Fitzgerald (part of Accenture).

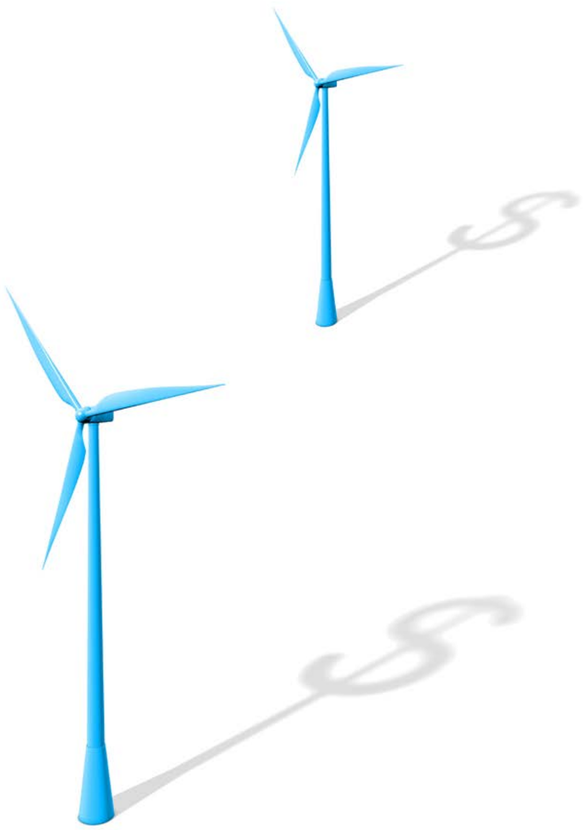
Already, financial regulators are placing greater demands on banks to demonstrate effective management of climate risks. In the UK, regulators are leading the charge, with the Prudential Regulation Authority (PRA) giving a deadline of end of 2021 for banks and insurers to fully embed climate-related financial risks. In addition, climate risk will be incorporated in the Bank of England's 2021 regulatory stress test scenarios. Pressure is also being applied to improve how firms report and disclose climate risks: voluntary disclosure regimes are showing signs of becoming mandatory, and financial regulators across jurisdictions are issuing consultations to inform rule making. In New Zealand, a law was recently passes forcing its financial sector to report the effects of climate change.

Banks have to overcome a number of hurdles to quantify and manage climate risks properly. It remains uncertain how the risks emerging from the transition to a low-carbon economy unfold over time. And how these will translate into financial impact on banks' counterparties. Allowing banks to respond effectively requires greater consistency, sophistication and availability of climate risk data, such as exposures at asset, locational, and supply chain levels.

Deciding when to act is challenging too. Many of the financial risks associated with climate change are unlikely to manifest within banks' typical financial planning cycle (of around four years). And the degree to which banks need to seek immediate action depends on the exposure of their balance sheets to climate risks.

What is becoming clearer to all concerned is that the impact of climate change can only grow as more of the risks and opportunities emerge. Managing it effectively should be an integral part of banks' efforts to strengthen risk-adjusted performance. Doing so requires banks to incorporate climate change considerations into their risk appetite and pricing, senior manager responsibilities and strategic planning in an explicit manner. This starts with establishing an appropriate governance process to approve the inclusion or exclusion of climate risks in their existing risk management framework.

It remains uncertain how the risks emerging from the transition to a low-carbon economy unfold over time. Allowing banks to respond effectively requires greater consistency, sophistication and availability of climate risk data—which may not be feasible under voluntary disclosure regimes.

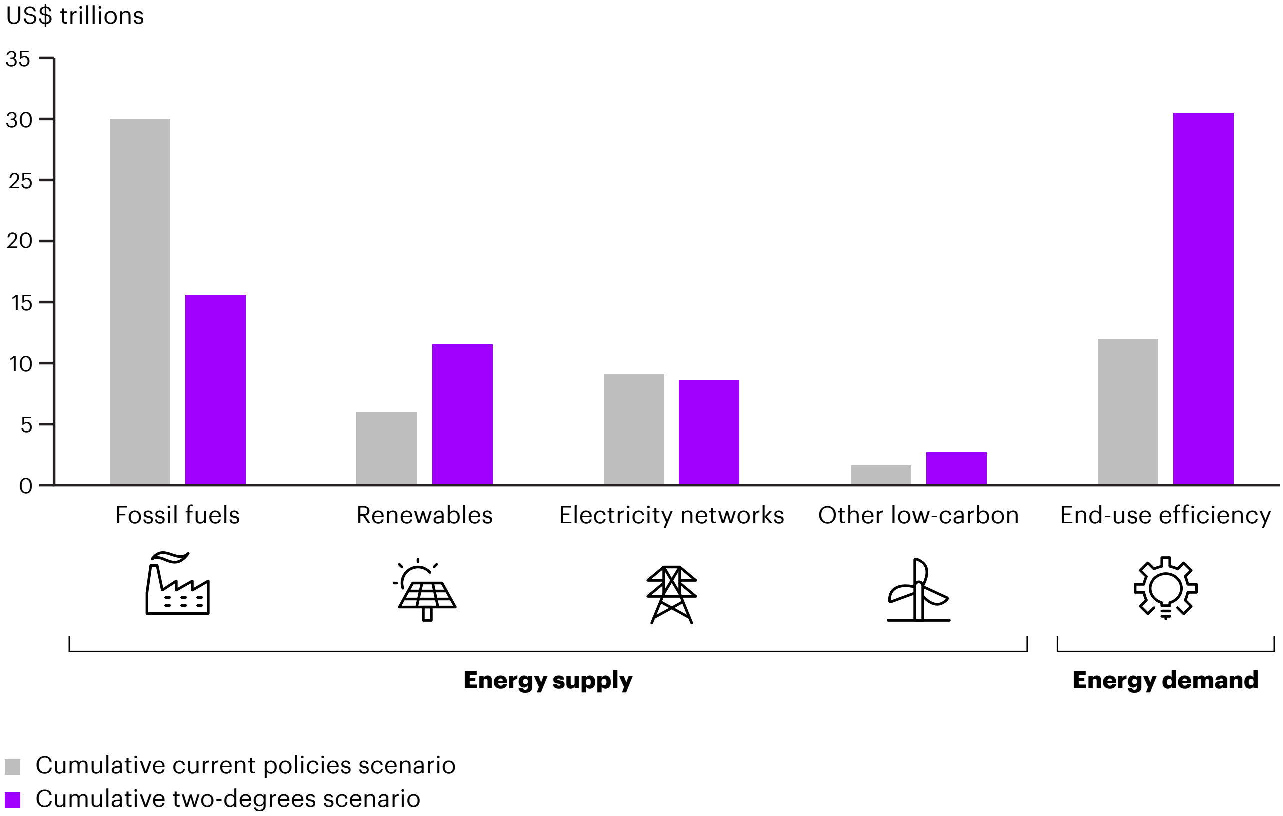


Quantifying the risk and return of climate change

The transition to a low-carbon economy is expected to shuffle the risks and returns of various assets, creating renewable assets and resulting in stranded assets.

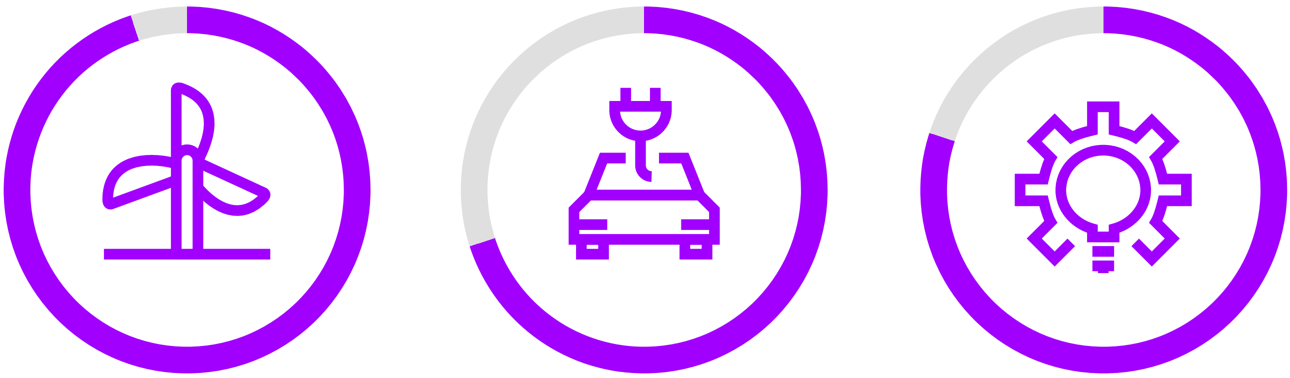
One analysis predicts that as much as one-third of the world's oil reserves, half of gas reserves and over 80% of coal reserves would need to remain unused from 2010 to 2050 in order to limit man-made climate change to a temperature rise of two degrees Celcius.[5]

Figure 1 – Capital re-allocation in the energy sector consistent with a two-degree pathway



Source: International Energy Agency, 2017.

In 2019, the UK became the first country to commit to a legally binding target of reducing greenhouse-gas emissions to net zero by 2050. Meeting this goal would require:



95%	<1% → 70%	80%
95% of electricity would need to be low-carbon.	70% of cars to be electric. Currently <1% are electric.	Reduce CO_2 emissions from industrial sector by 80%.

Source: International Energy Agency 2017.

The UK subsequently published its Green Finance Strategy,[6] with the objective of mobilizing greater volumes of private capital for sustainable finance and strengthening the UK's international leadership in this space.

Globally, the pandemic has both heightened the awareness of horizon risks (such as climate) and mainstreamed environmental, social and governance (ESG) considerations in recovery packages. Thirty percent of the European Union's long term budget between 2021 and 2027 is earmarked for fighting climate change.[7]

This has, in turn, accelerated policymaking and reinforced regulatory momentum. The European Commission has launched comprehensive packages covering topics from defining sustainable economic activities (through the European Union Taxonomy) to mandating disclosure of sustainability risks in financial products (e.g. European Union Disclosure Regulation). There have also been extensive amendments to existing prudential packages and legislative frameworks (e.g. CRDV, MiFID II).[8]

In the U.S., the new administration has already reinstated the country to the Paris Agreement.[9] The U.S. Fed is homing in on climate risk by setting up a new Supervision Climate Committee.[10]

Risk implications for banks

The OECD estimates that US$6.9 trillion of investment would be required each year to 2030 to meet the Paris Agreement goals.

As the financier and custodian of the economy, banks and other financial institutions have a critical role to play in safeguarding firms and industries during the transition to the new climate paradigm. This calls for both the mobilization of private finance to fund the transition and effective management of the implications of a low-carbon economy for countries, industries and companies that banks support.

Given the large sums of capital required, and the exposures to climate risks already locked into financial markets, banks have significant opportunities from sustainable finance products while facing significant risks from both climate change itself (physical risks) and mitigation measures (transition risks).

According to the climate disclosures of 45 global financial institutions, the financial impact of climate-related opportunities and risks is estimated to be around US$2 trillion for financial services (see Figure 2). An impact of this scale is likely to change the ways in which financial institutions assess and manage opportunities and risks, both financial and non-financial. These would redial the parameters of existing risk taxonomies that govern the ways in which financial institutions assess and manage risks. In the UK, discussions between the PRA and banks have focused on assessing the impact of climate-related risks on banks' existing risk management frameworks and on the value of their assets (see Figure 3).

Climate risks are expected to have widespread implications across the entire risk taxonomy, that is, what is considered credit risk, market risk, and operational risk. A PRA survey of UK banks revealed that 90% are able to identify examples relating to credit risk, 70% to operational risk and 20% to market risk.[11]

Figure 2 – Impact of climate-related opportunities and risks on financial services (US$ bn)

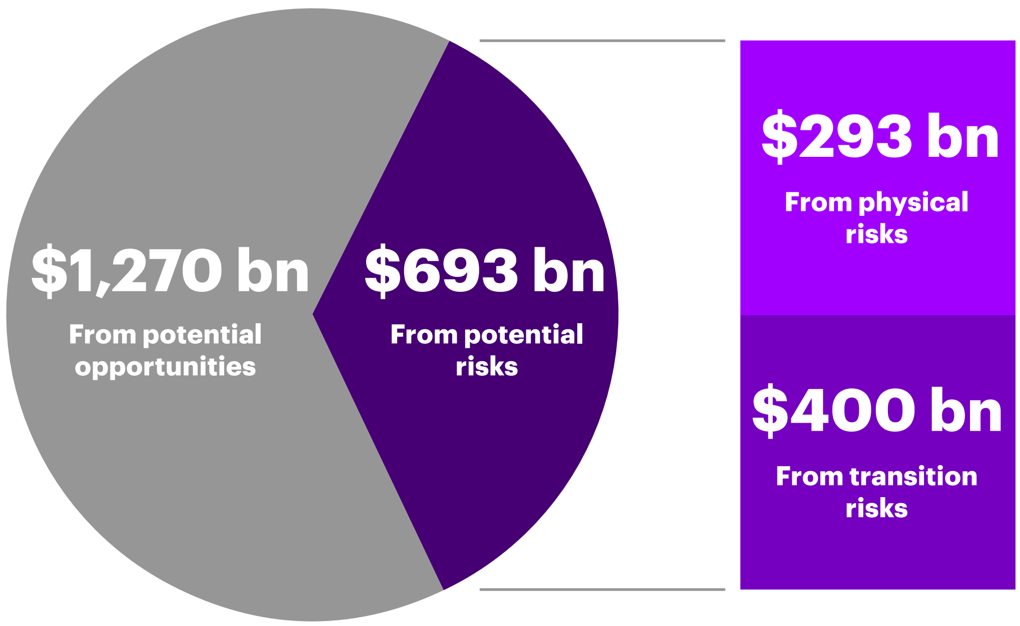


Figure 3 – Examples of balance sheet exposure in banking sector

	Credit	Market	Operational
Examples of Physical Risks	Increased flood risk to a bank's mortgage portfolio Reduction in agricultural output with increase in default rate	Severe weather events leading to re-pricing of sovereign debt	Severe weather events impacting business continuity
Examples of Transition Risks	Tightening energy efficiency standards impacting property exposures Stranded assets impairing loan portfolios Disruptive technology resulting in auto finance losses	Tightening climate-related policy resulting in the re-pricing of securities and derivatives	Evolving sentiment on climate change issues resulting in reputational risk exposure
UK Banking Sector Exposure*	75%	14%	10%

* Measured as a percentage of risk-weighted assets

Source: Transition in thinking: The impact of climate change on the UK banking sector, Bank of England, September 2018. Banking sector regulatory capital, Bank of England, Q1 2018.

Regulatory expectations

Financial regulators and central banks are placing greater demands on financial institutions to demonstrate that they are effectively managing credit, market, operational and other risks within their existing risk management frameworks.

Pressure is also being applied to financial firms to improve how they report climate risks, not just to the regulator, but also to the wider market. Greater disclosure and market transparency are key regulatory tools in driving the shift towards a more sustainable financial system.

The speed with which banks address these emerging risks has been identified as an area for improvement. Mark Carney, former Governor of the Bank of England and the United Nations Special Envoy for Climate Action and Finance, coined the term "the tragedy of the horizon" to describe the mismatch between financial institutions' current planning cycles and the long-term impact of climate change and mitigation policies.[12] Indeed, according to a PRA survey, while a majority of banks are starting to treat risks from climate change as financial risks, these tend to be beyond firms' usual planning horizon of roughly four years.[13]

Accelerating action to circumvent "the tragedy of the horizon" requires banks to make adjustments to their risk appetite, investment horizons, and balance sheet management. Regulators and financial institutions should join forces in recalibrating capital and risk models to improve alignment with the impact of climate change and mitigation policies. Doing so effectively requires not only the nuanced understanding of the exposures of banks' balance sheets to climate-related risks, but also greater regulatory clarity on the prudential treatment of environmental exposures.

The UK regulators have taken a step further to examine how firms have integrated the financial risks from climate change into their risk identification and risk appetite, the use of climate scenarios to assess longer-term exposures and the maturity of more granular, bottom-up analysis to estimate potential exposures (see Figure 4).

The PRA has published a Supervisory Statement (SS3/19) which aims to enhance and align the approaches taken by banks and insurers in managing the financial risks associated with climate change.[14] In July 2020, Sam Woods, CEO of the PRA, further clarified the regulator's expectation that firms fully embed their approaches to managing climate-related financial risks by the end of 2021, and that a "full range of regular supervisory activities" would be deployed.[15] The PRA statements made it clear that addressing environmental risks is not simply about developing renewable products. Climate change constitutes a unique set of challenges which require a strategic response from banks and insurers as they manage risks across their business.

The emphasis on "strategic" is critical. Boards should incorporate climate risks in risk management frameworks, policies and procedures, as well as key management information, to allow for effective monitoring, management and oversight. Senior management roles and responsibilities should be clearly allocated.[16]

Figure 4 – Managing climate-related financial risks: UK regulatory expectations

	GOVERNANCE	RISK MANAGEMENT	SCENARIO ANALYSIS	DISCLOSURE
Description	Embed considerations of financial risks from climate change in governance arrangements	Incorporate the financial risks from climate change into existing risk management framework and practices	Adopt proportionate and integrated approach to scenario analysis by the end of 2021	Develop an approach to disclosure on the financial risks (to the firm) from climate change
Regulatory Expectations	Financial risks from climate change should be incorporated into the most appropriate, existing senior management function The PRA expects to see proof that the board and its relevant sub-committees exercise effective oversight of risk management and controls The PRA expects firms to provide the board and relevant sub-committees with management information on their exposure to the financial risks from climate change	As part of the Own Risk and Solvency Assessment (ORSA) or the Internal Capital Adequacy Assessment Process (ICAAP), financial firms should include, as a minimum, all material exposures pertaining to the financial risks from climate change The PRA expects to see proof of how a financial firm monitors and manages the financial impact of climate-change-related risks in line with risk appetite statements. This should take into account the results of stress and scenario testing and sensitivity of the balance sheet	The PRA expects a firm's scenario analysis to address a range of outcomes relating to different transition paths to a low-carbon economy, and a path where no transition occurs Scenario analysis should consider short-term assessment which sets out the firm's exposure to the financial risks from climate change, and longer-term assessment of the firm's exposure, based on its current business model, and a range of different climate-related scenarios	Comply with existing requirements to disclose, in a strategic report, information on material risks within Pillar 3 disclosures and on principal risks and uncertainties The PRA expects firms to develop and maintain an appropriate approach to disclosure, reflective of the distinctive elements of the financial risks from climate change
Areas for Improvement	Consistency in management information reporting and development of tools to inform business decisions Clearer understanding of the risk transmission channels and interactions between multiple lines of business, sectors and geographies	Enhance the use of proxies and assumptions when metrics and quantification are insufficient to estimate risks Improve the risk management process and the integration of policies, thresholds, mitigation strategies, monitoring capabilities and risk appetites	Materially improve data, tools and capabilities necessary to integrate scenario analysis into a firm's broader risk assessments	Materially improve climate disclosure capabilities to promote industry progress and consistency

Source: "Enhancing banks' and insurers' approaches to managing the financial risks from climate change," Supervisory Statement 3/19, Prudential Regulation Authority, April 2019.

"Managing climate-related financial risk – thematic feedback from the PRA's review of firms' Supervisory Statement 3/19 (SS3/19) plans and clarification of expectations," Dear CEO Letter, Prudential Regulation Authority, July 2020.

The current requirements for banks to make Pillar 3 disclosures relating to material business risks could also be further enhanced by the PRA in the light of initial feedback from the banks.

In addition, the PRA and the Financial Conduct Authority (FCA) have created the Climate Financial Risk Forum (CFRF), combining the expertise from a group of regulated firms, which aims to develop "best practice" approaches to identifying, mitigating, and managing these risks.[17] In June 2020 the CFRF published its guides to help financial institutions incorporate climate change in their risk management and strategic decision making.[18] The PRA's work should also inform the Bank of England's efforts to identify, monitor and remove or reduce systemic risks to the UK's financial system – the Bank is planning to include climate change stress tests in the Biennial Exploratory Scenario (BES) stress test.[19]

The UK is not alone in further developing its regulatory framework – the European Banking Authority has set up a comprehensive and sustainable finance action plan (see Figure 5). French and Canadian regulators, for example, have provided new guidance to assist financial institutions to assess the materiality or relative importance of climate-change-related risks, setting out key questions boards should consider in preparing for and disclosing climate risks. This includes assessing their expertise across short, medium and long-term climate risks, avoiding boilerplate disclosures and consulting on existing frameworks such as the Financial Stability Board (FSB) Task Force on Climate-related Financial Disclosures (TCFD) and the Sustainability Accounting Standards Board (SASB).[20]

We are seeing jurisdictions like Singapore, the US and the EU draw upon the UK's regulatory framework when it comes to climate risk.

Figure 5 – European Banking Authority (EBA) Action Plan on Sustainable Finance

Milestones and implementation challenges

STRATEGY and RISK MANAGEMENT

Credit Granting and Monitoring
Inclusion of **ESG-related requirements** for credit granting and monitoring processes

Green Lending Policies
Development of **specific policies and procedures** covering such credit facilities

Supervisory Review
Inclusion of considerations about the methods for **identifying and managing the impacts of ESG risks**

KEY METRICS and DISCLOSURE

Market Disclosure
Identification and disclosure methods of **key qualitative and quantitative metrics** to be a key component of the EBA's work

Non-Financial Reporting
Inclusion of **ESG-related disclosure** in the existing EBA Guidelines, including the reporting of **climate-related information**

STRESS TEST and SCENARIO ANALYSIS

Climate Stress Test
Development of a **dedicated climate change stress test** for identifying banks' vulnerabilities

Stress Testing Framework
Update of the **guidelines related to risk management and stress testing**, including qualitative and quantitative criteria to evaluate the impact of **ESG factors**

PRUDENTIAL TREATMENT

Dedicated Prudential Treatment
Evaluation of a dedicated prudential treatment considering the **exposures related** to assets or activities associated with **environmental** or **social objectives**

June 2021
Final report on ESG risk integration in risk management and supervision

June 2021
Final draft of Implementing Technical Standards (ITS) on Pillar 3 disclosure; Regulatory Technical Standards (RTS) on consumer and investor disclosure

2021
EU-wide stress test to include climate change scenarios in 2022

2022-24
Ongoing engagement and possible updated/new EBA Guidelines

Source: European Banking Authority Action Plan on Sustainable Finance, December 6, 2019.
The plan is to remain in place for the next 4 years.

Improving financial disclosures

Improved risk management requires improved market disclosure.

By encouraging financial firms to publish climate risk data through voluntary codes, or mandating firms through legislation, it is possible to create discipline around the collating, analysis and interpretation of data. This, in turn, can lead to a more efficient allocation of capital in which climate risks are fully priced in.

However, climate-related disclosures can be particularly demanding. Past incidences have little predictive power for the future as the changes in climate trends are rarely “linear.” Adding to the challenge, significant disparities can exist between the industry-level impact and that on the individual firms within an industry.

Making sense of the potential impact of climate change and forming a strategic response are also difficult due to interconnected global supply chains and a multitude of intersecting legal, regulatory and operating environments.

In 2015, the FSB reviewed how the financial sector could take account of climate-related issues to help inform investment, lending, and insurance underwriting decisions, and to improve understanding and analysis of climate-related risks and opportunities.[21] The industry-led TCFD was created to develop solutions. The TCFD’s recommendations span governance, strategy, risk management and target metrics. They were designed to be applicable to both financial and non-financial institutions across sectors and geographies.[22]

The latest progress report (published in October 2020) highlights that TCFD is supported by 1,500 firms globally, with a market capitalization of US$12.6 trillion and financial institutions responsible for assets of over US$150 trillion.[23]

However, inconsistencies remain across firms. Within financial services, there is currently a varying degree to which firms explicitly link disclosures to specific TCFD recommendations, hence hindering comparability across firms. In addition, even though many firms provide qualitative information and some share quantitative scenario analysis results, few disclose their criteria for materiality of climate change risks.

The progress in climate disclosures also varies across industries: while global banks would appear to lead the pack, many large companies in other industries have yet to fully align with the TCFD recommendations. This should likely result in incomplete market data across companies, sectors and countries, in turn limiting the ability of banks to fully assess the nature of climate risks on the physical assets they lend against or invest in.

As part of the UK’s climate change strategy, the government has set an expectation for all listed companies and large asset owners to disclose as per the TCFD recommendations by 2022.[24] However, the FCA observed in 2019 that only a third of premium-listed companies in the UK were making the relevant reports.[25] This rate of progress may be too slow to effectively inform financial markets and institutions of the risks associated with climate change.

The current rate of progress also falls short of the Chancellor of the Exchequer's ambition of making the UK the first G20 country to make TCFD-aligned disclosures fully mandatory—moving beyond the "comply or explain" approach—across the economy by 2025.[26]

Within financial services, there is currently a varying degree to which firms explicitly link disclosures to specific TCFD recommendations, hence hindering comparability across firms.

Figure 6 – TCFD recommendations and supporting recommended disclosures

Governance	Strategy	Risk Management	Metrics and Targets
Organization to disclose its governance as it pertains to climate-related risks and opportunities	Disclose the material impact (actual and potential) of climate-related opportunities and risks on the organization's strategy, financial planning and businesses	Disclose how the organization plans to identify, assess and manage its climate-related risks	Disclose metrics/targets to be used by the organization to evaluate and manage key and material climate-related risks and opportunities
Recommended Disclosures			
Describe the board's oversight of climate-related opportunities and risks	Describe the short, medium and long-term climate-related risks and opportunities identified by the organization	Describe the process used by the organization to identify and assess climate-related risks	Disclose the metrics used to assess climate-related risks and opportunities in line with the organization's strategy and risk management process
Describe management's role in the assessment and management of climate-related risks and opportunities	Describe the impact on the organization's businesses, strategy and financial planning of climate-related risks and opportunities	Describe the process used by the organization to manage climate-related risks	Disclose the organization's Scope 1, Scope 2, and if appropriate, its Scope 3 greenhouse gas emissions and related risks
	Describe the resilience of the organization's strategy. This should take into consideration different climate-related scenarios, including a 2°C or lower scenario	Describe how the processes used by the organization to identify, assess and manage climate-related risks are integrated into its overall risk management	Describe the targets to be used by the organization to manage climate-related risks and opportunities, and its performance against each

Source: Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures, June 2017.

Where next?

Climate-related risks are multi-faceted and dynamic. The materiality of physical climate risks can change unexpectedly due to climatic or technological developments.

At the same time, how risks emerging from the transition to a low-carbon economy unfold and remain uncertain. To allow banks to respond effectively requires greater consistency, sophistication and availability of climate risk data.

Deciding when to act is equally challenging. Many of the financial risks associated with climate change are unlikely to manifest within banks' current financial planning cycle (which is around four years). And the degree to which banks should seek immediate action depends on the exposure of their balance sheets to climate issues. For example, physical risks are more immediately relevant for banks with a high share of products with a long loan term (e.g. mortgages) while transition risks are more important for those with a greater portion of commercial loans to certain industry sectors.

At Accenture, we help clients understand the strategic impact of changes in the economic, regulatory and industry environments on the risk profile of their firms. This includes assisting clients to respond to stress testing requirements, build and compare stochastic and statistical risk models, as well as engage with regulatory authorities.

Through our knowledge of key regulatory authorities and industry groups, we provide critical insight on the direction of policy making that can help clients make well-informed decisions on investment in new capabilities. For more information, please contact any of the authors.

What appears certain is the growing impact of climate change on banks over time. As such, all institutions should have in place an appropriate governance process to approve the inclusion or exclusion of climate risks in their overall risk management framework. This requires banks to take four key actions as a no-regret move:

Adjust risk appetite

Climate risk is expected to affect all risk types and the considerations should be incorporated into the risk appetite of each existing type within the risk taxonomy, rather than having a separate climate risk category.

Create a climate risk register

Banks should both gain a point-in-time view of their exposure to climate risks and conduct regular monitoring to identify relevant risks that require active management.

Conduct framework gap analysis

Banks should enhance their climate risk capabilities, reflecting changes to the relevant climate risk register.

Quantify and measure climate risks

Develop data and analytical tools, proportionate to exposure, and support active risk management and scenario analysis.

Ultimately, the effective management of climate risk should be an integral part of banks' efforts to enhance risk-adjusted performance amid an evolving risk landscape and increasing regulatory complexity. This requires banks to incorporate climate change considerations in product innovation, capital management, business planning and strategic transactions in an explicit and deliberate manner.

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