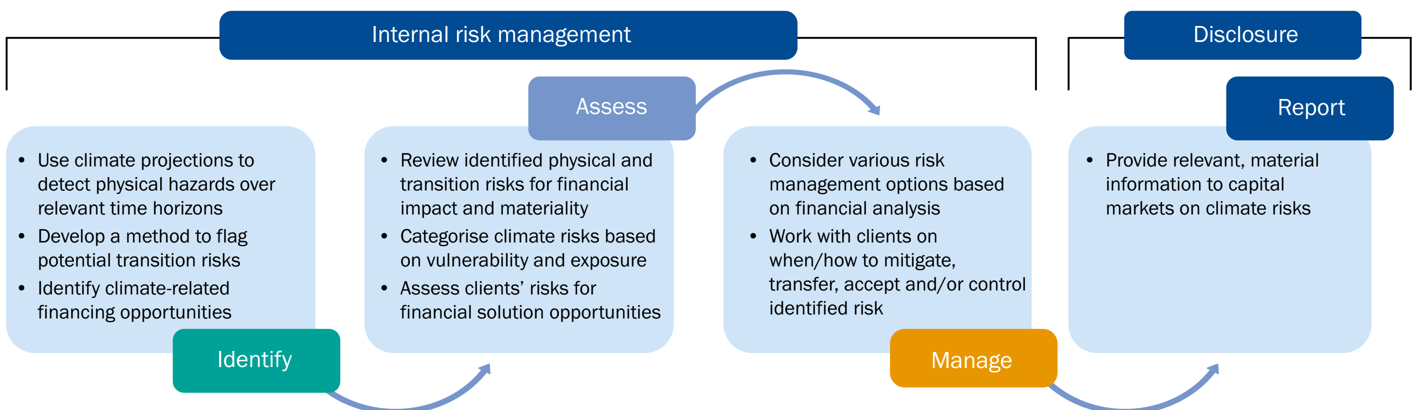
Climate risk management for financial intermediaries

Introduction

For financial institutions, climate risk refers to the financial effects on clients of a changing climate. A large part of an FI's climate risk is in its loan portfolio, which will become apparent in unexpected changes to a client's cash flows. However, financial institutions also experience climate risk through impacts on tradeable securities, including an FI's bond holdings. These risks can manifest in material changes in asset values due to fluctuations in expected revenues and costs, as well as the value of capital assets. Climate risk can be divided into two categories: transition risk and physical risk.

The financial impacts of climate risk, including changes in corporate profitability, household income and gross domestic product growth, affect individual FIs and can become concentrated in the financial system, resulting in systemic contagion. What is more, responding to climate change by restructuring the economy towards lower-carbon intensity and building resilience to physical climate changes **requires significant amounts of capital**, presenting a considerable **opportunity** for the financial sector, especially those first movers who can swiftly identify and assess the risks.

Figure 1. Climate risk management for financial intermediaries



The EBRD climate risk approach for FIs

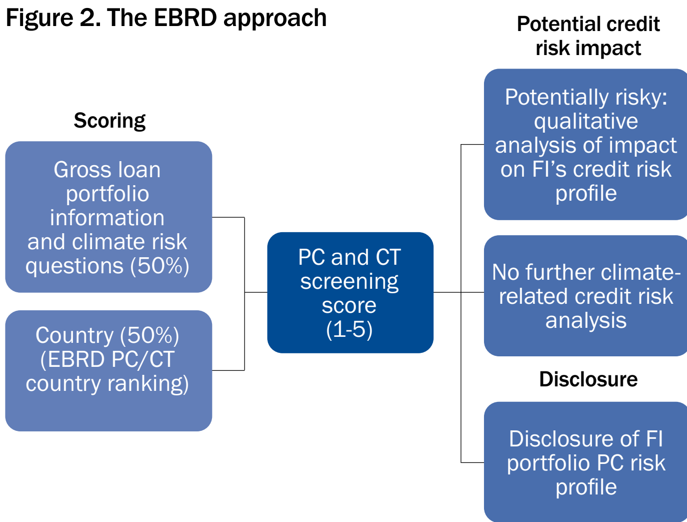
The EBRD is focused on integrating this relatively new financial risk into its existing financial risk management process. The Bank has developed a questionnaire to help identify the potential climate risk exposure of its financial intermediary (FI) clients and assess these risks for materiality to the client, as well as the EBRD. It concentrates largely on the FI's loan portfolio and internal climate-risk management integration.

For the majority of financial institutions (and companies), climate risk is a blind spot – a risk that is assumed without knowing. As past data cannot be used to identify climate risk (due to the nature of climate change), the identification process relies on assumptions about future climate scenarios and the forecast impacts of those scenarios. Only by identifying and assessing (physical and transition) climate projections can an organisation effectively manage these risks in the most efficient way and better understand the risk it is taking on through new financing approvals.

The EBRD uses these data to develop screening scores for physical climate (PC) and carbon transition (CT) risk.

In 2017, the Task Force on Climate-related Financial Disclosures issued its first recommendations for integrating climate risks into normal risk management operations. These provide a useful framework for the management of such risks, regardless of whether an FI decides to disclose these risks.

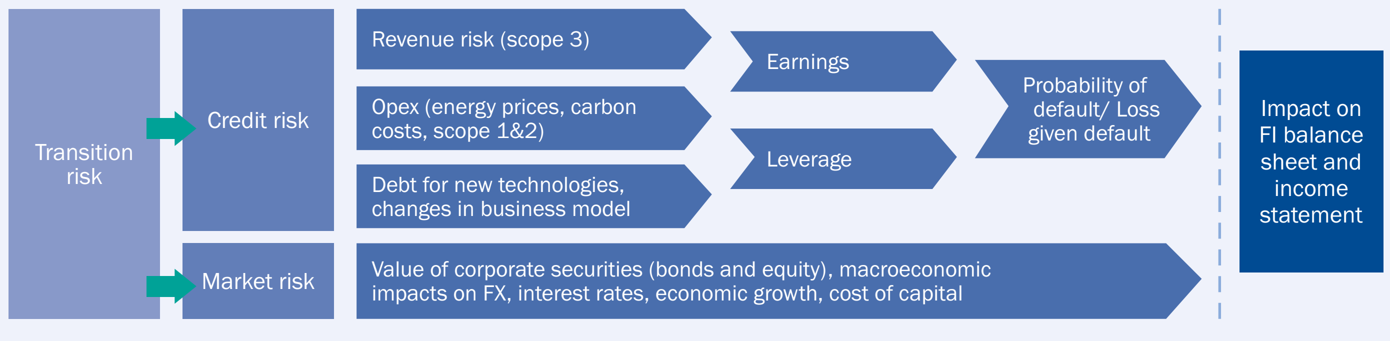
Figure 2. The EBRD approach



Transition risk

Transition risk is the financial impact on an FI's clients from the international response to climate change and the economic reorganisation already underway to this end. Identifying the climate risks to which a client's business model is exposed and assessing those risks for material impact on the client, as well as the FI, allows an FI to improve its internal risk management and discover new financing opportunities with existing clients or growing industries. Responding to climate change by restructuring the economy towards lower carbon intensity and building resilience to physical climate changes requires significant amounts of capital and presents a considerable opportunity for the financial sector, especially first movers.

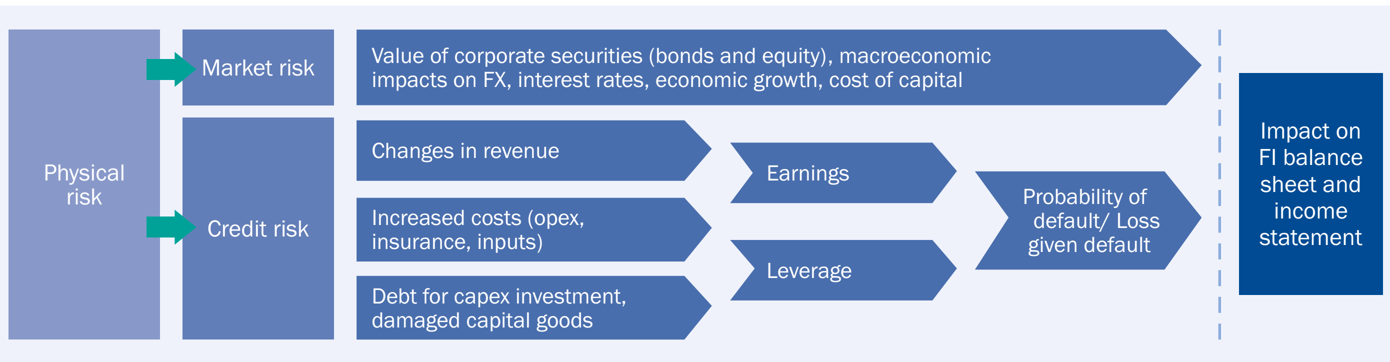
Figure 3. Identifying climate risk



Physical climate risk

Physical climate risk is the financial impact on an FI's clients of the physical hazards associated with climate change. These include both chronic physical risk (such as changes in average precipitation, sea-level rise) and acute physical risk (for example, flooding, wildfires, cyclones and extreme heat).

The changing frequency and intensity of these hazards creates unforeseen risk and may result in material divergence from expected profitability.



Portfolio

The EBRD reviews each FI every two years to monitor changes in its climate risk profile and, hence, the climate risk profile of the Bank itself. As FI clients develop processes for incorporating climate considerations into their own investment decisions, exposure to this risk should decrease for the FI client, the EBRD and the broader economy in which the FI operates.

This biennial review is based on the FI client's integration of climate considerations into its investment approval process, as well as its exposure to generally riskier sectors in its gross loan portfolio.

In some cases, this may require additional reporting to the EBRD on identified climate-related financial risks.

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