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Managing a new financial risk: Climate Risk

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CLIMATE RISK HAS BECOME A BOARD LEVEL ISSUE FOR MANY INSTITUTIONS

Frequent and severe physical risk events

The need for change to meet 2015 Paris agreement targets becoming increasingly clear

UN Sustainable Development Goals

Corporations aligning around contribution to the UN's 2030 SDG targets

Integration of ESG standards in investment process

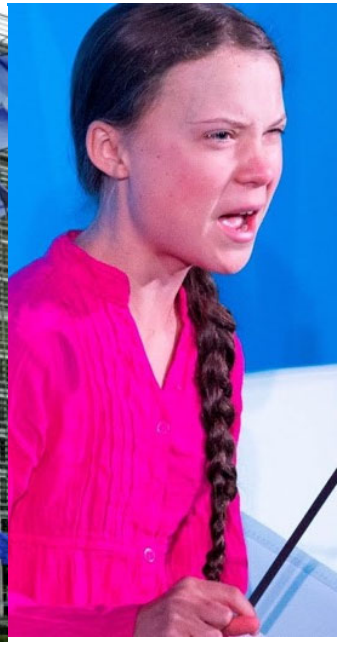
Intensifying investor and shareholder advocacy, and increasing green and transition financing

Increasing transparency

External disclosure becoming expected; institutions signing up to TCFD, Principles of Responsible Banking, etc

Increasingly high environmental standards

e.g. ECB including climate and ESG in prudential standards, EU green deal, EBA action plan for sustainable finance…



Greta at Davos

Rising pressure from the general public and NGOs

CLIMATE CHANGE REPRESENTS BOTH FINANCIAL AND REPUTATIONAL RISKS TO FINANCIAL INSTITUTIONS

Potential Reputational risk ⟷ *Potential Financial risk*

What is the contribution of my institution to climate change ?

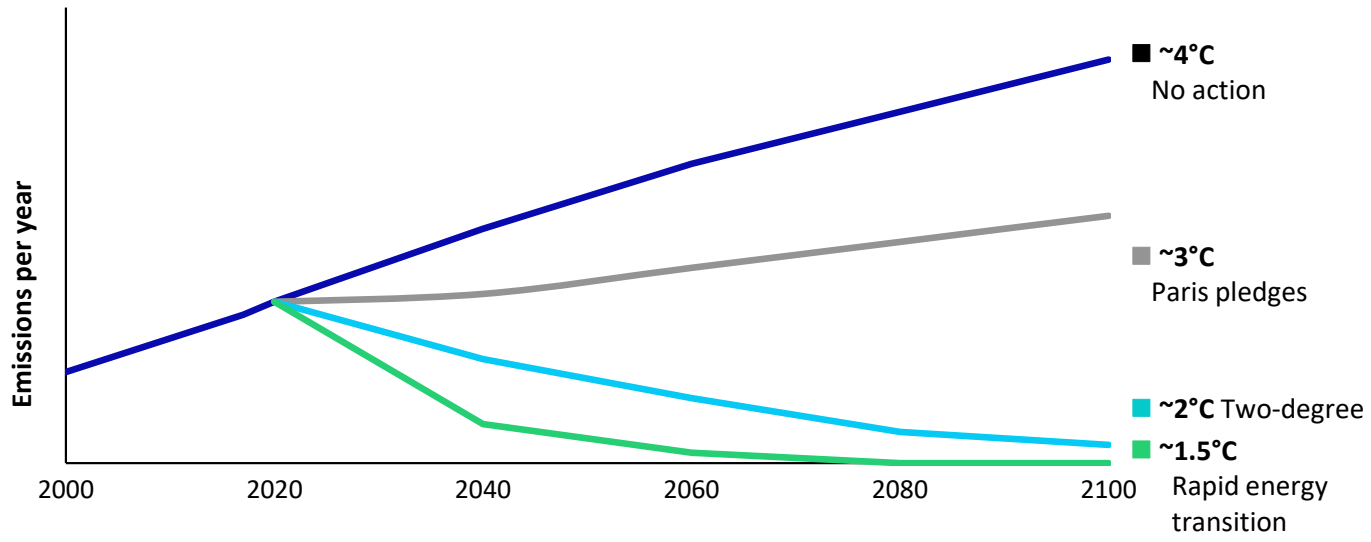
E.G
Financed emissions
Portfolio warming potential
Sector exclusions

What is the potential impact of climate change on my institution ?

E.G
Credit losses
Falls in market value
Stranded Assets

POLICIES AND BEHAVIOURS WILL DRIVE WHICH FORM OF CLIMATE FINANCIAL RISK WILL PREVAIL

CO_2 emission trajectory and corresponding climate change scenarios



Regardless of the path we take, we will face climate risks

Browner scenarios
More physical risk

Sea level rise, flooding, wildfires, wind storm etc.

Greener scenarios
More transition risk

Carbon tax, ban on conventional vehicles, new technologies, change in consumer behaviour, etc.

Comments:

- Higher global warming will lead to increasingly severe climate impacts (i.e. physical risks such as storms, floods, fires, droughts)
- The 2015 Paris agreement set an aspiration to limit post-industrial global warming to well under 2°C (with a target of 1.5°C). This will require global emissions to fall to less than half of 2010 levels by 2050[1]
- Paris signatories have set national pledges to reduce emissions by mid century ("Nationally Determined Contributions" - NDCs) – in aggregate these fail to meet the Paris targets and will result in global warming of ~3°C.
- Transition to a low carbon economy will require significant policy changes (e.g., carbon taxes), new innovations (e.g., direct air capture, hydrogen and EVs) and behavioural changes (less flying, less red meat etc), leading to increased transition risks

1. IPCC Fifth Assessment Report (AR5)

THE IMPACT OF TRANSITION RISK WILL BE DRIVEN BY SECTOR AND COMPANY SPECIFICS – GRANULAR ANALYTICAL CAPABILITIES WILL BE CRUCIAL

TRANSITION RISK

SCENARIO ANALYSIS

Choose Climate Scenario

Late policy action

Choose Sector

Oil and gas

Choose Geography

World

Choose Customer

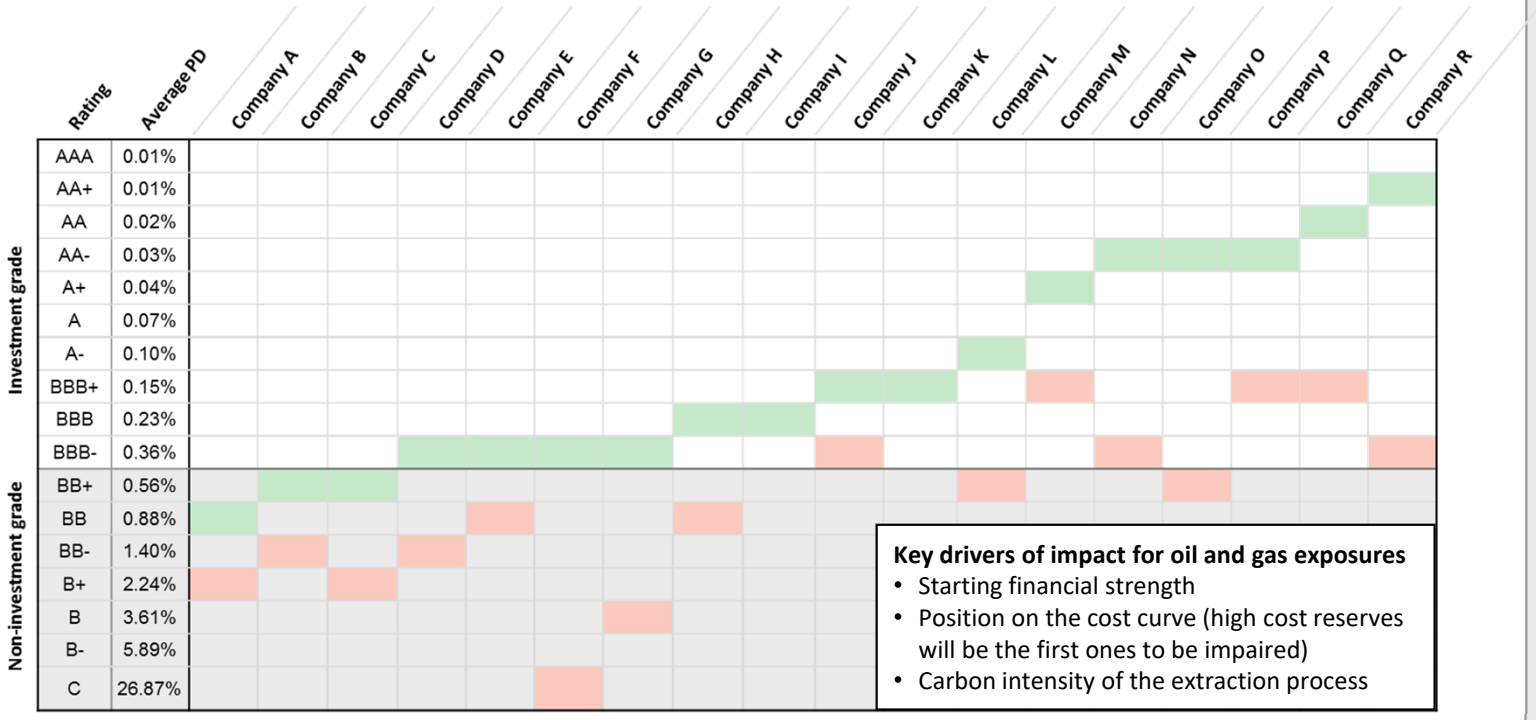
All

CALCULATE

Late policy action | Early policy action | No additional action | Internal scenario 1

Example: Sudden implementation of a carbon tax

Starting rating | Ending rating



Key drivers of impact for oil and gas exposures

- Starting financial strength
- Position on the cost curve (high cost reserves will be the first ones to be impaired)
- Carbon intensity of the extraction process

SOME CHALLENGES TO BEAR IN MIND

01 No ‘playbook’ for how to quantify (especially physical risk)

02 The need for counterparty-specific information & insights

03 Lack of history to build from – where’s the data?

04 Mobilising the organization around an uncertain future risk

05 Where and how to embed in risk management processes

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