Preventing a ‘Climate Minsky Moment’: environmental risks and prudential exposure thresholds

Designing a transition-aligned Large Exposures threshold framework

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Contents

Financial Risks and the Challenges of a Net Zero Transition

Climate-related Financial Risks

- **Physical Risk** – extreme weather events and chronic changes in weather patterns.
- **Transition Risk** – implications for the economy as a consequence of progressing towards a net-zero economy.
- **Liability Risk** – A subset of the other two types, where financial compensation is sought for damages from climate change.

Primary Drivers of Transition Risk

Climate Policy

Changes in policy or implementation of climate policy, e.g., a carbon tax.

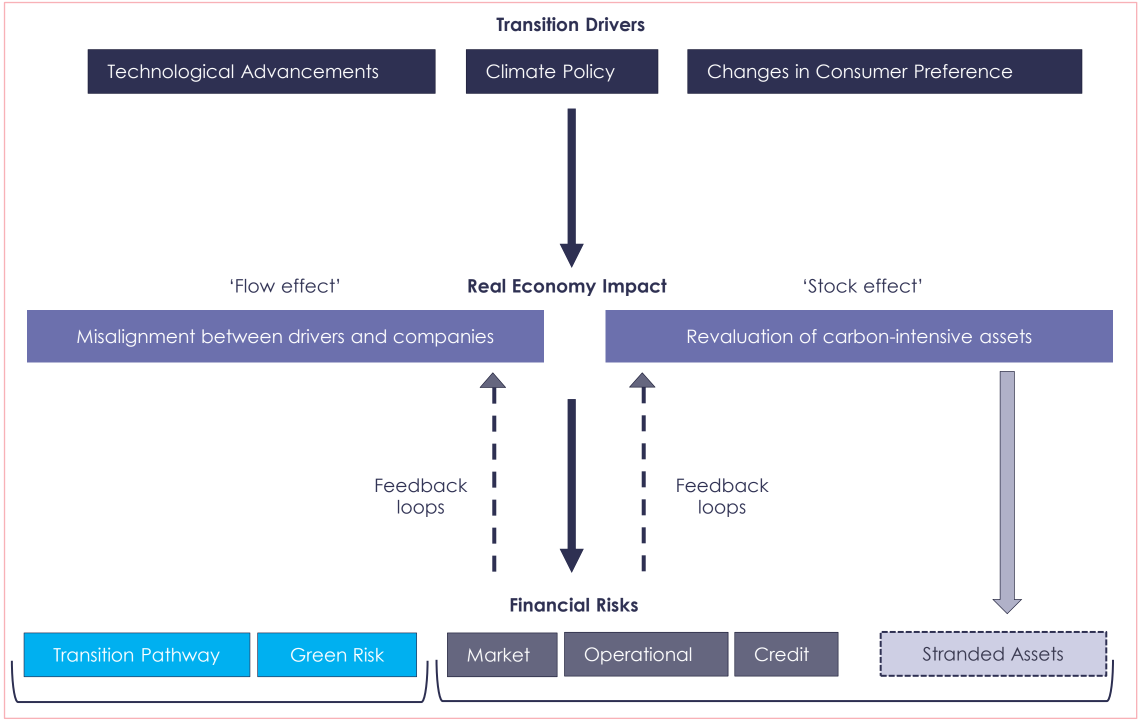
Technological Advancements

Low-carbon technology may disrupt expected future cash flows from carbon-intensive technologies.

Shifts in Consumer & Investor Preference

Greater awareness of climate-related issues leads to sudden shifts in spending and investment.

Transmission channels of climate transition risks



Challenges for Central Bank Measures

Lack of data on climate-related risks

- Lack of disclosing companies and forward-looking data

Unique risk characteristics of climate

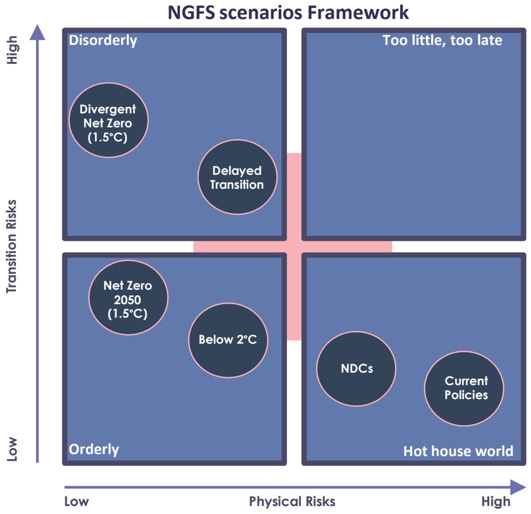
- Forward-looking, endogeneity, deep uncertainty, time horizon

Intra-industry differences in transition risk

- Exposure to transition risk differs on a company and asset-level

NGFS Transition Scenarios

- Orderly Transition – early, ambitious action
- Disorderly Transition – action is late, sudden and disruptive
- Too little, too late – a late transition which fails to contain physical risks
- ’Hot House’ World – limited action leads to hot house world with significant warming

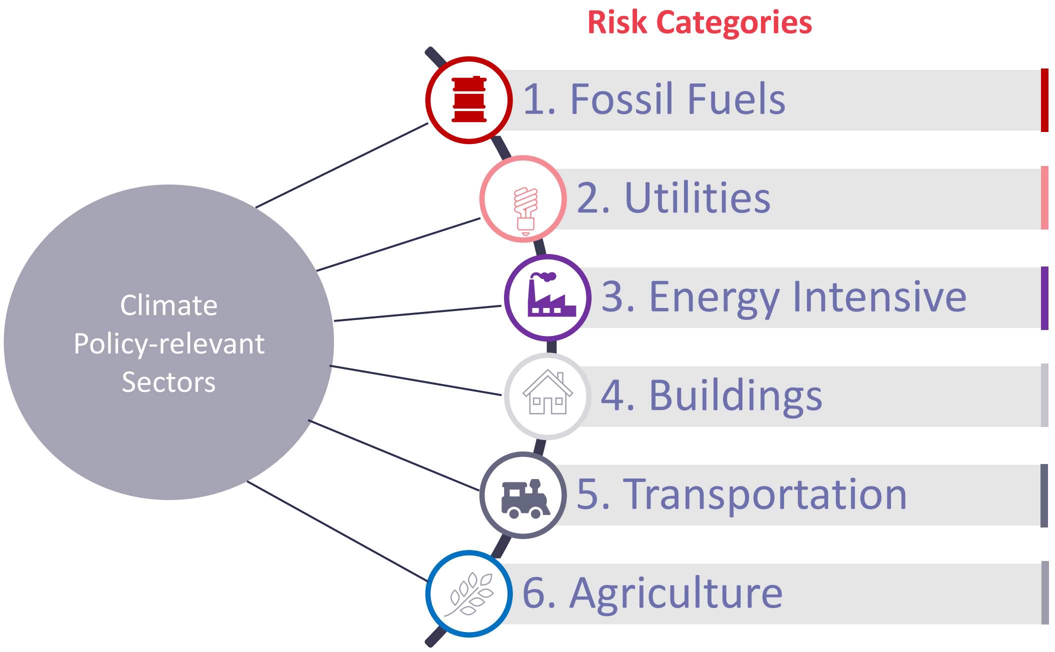


Identifying and Assessing Transition Risks to Establish Materiality and Exposure

Climate Policy-Relevant Sectors (CPRS)

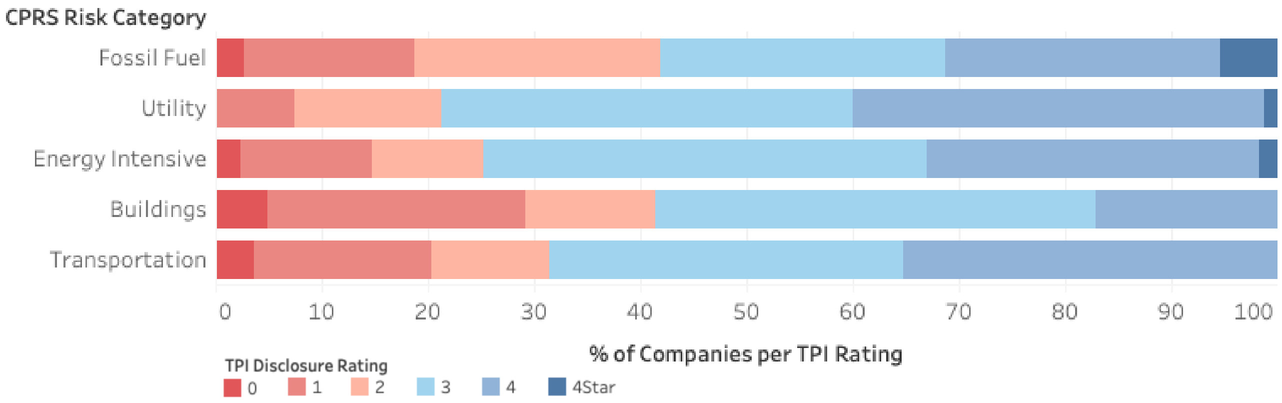
Sectors selection criteria:

1. Direct/indirect contribution to GHG emissions;
2. Relevance for climate policy implementation;
3. Their role in the energy value chain.



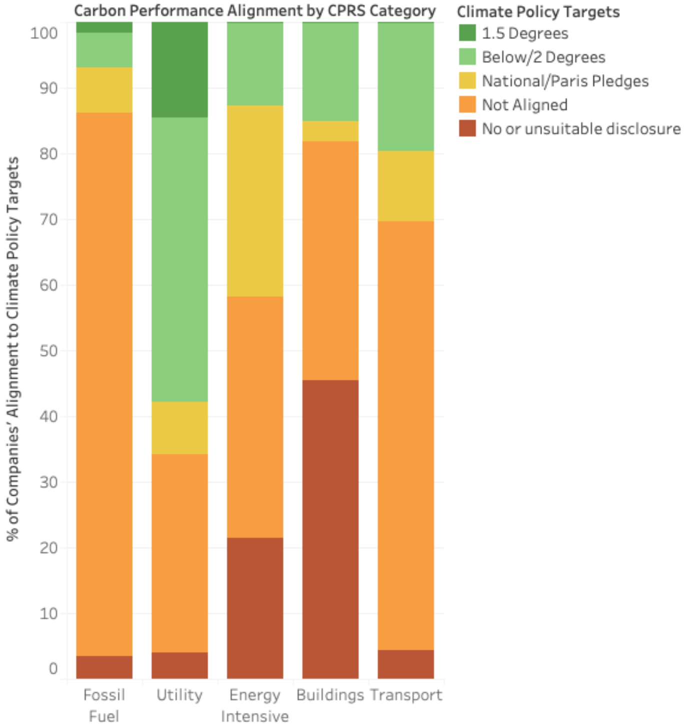
Assessment of Transition Risk in CPRS

- **TPI Rating Scale for Management Quality**
  - 141 out of 468 (30%) achieved a score of 2 or below, with over 40% of ‘Fossil Fuel’ and ‘Buildings’ companies achieving this score.
    - Only 10 companies in the sample disclosed a fully adequate strategic assessment on climate change.



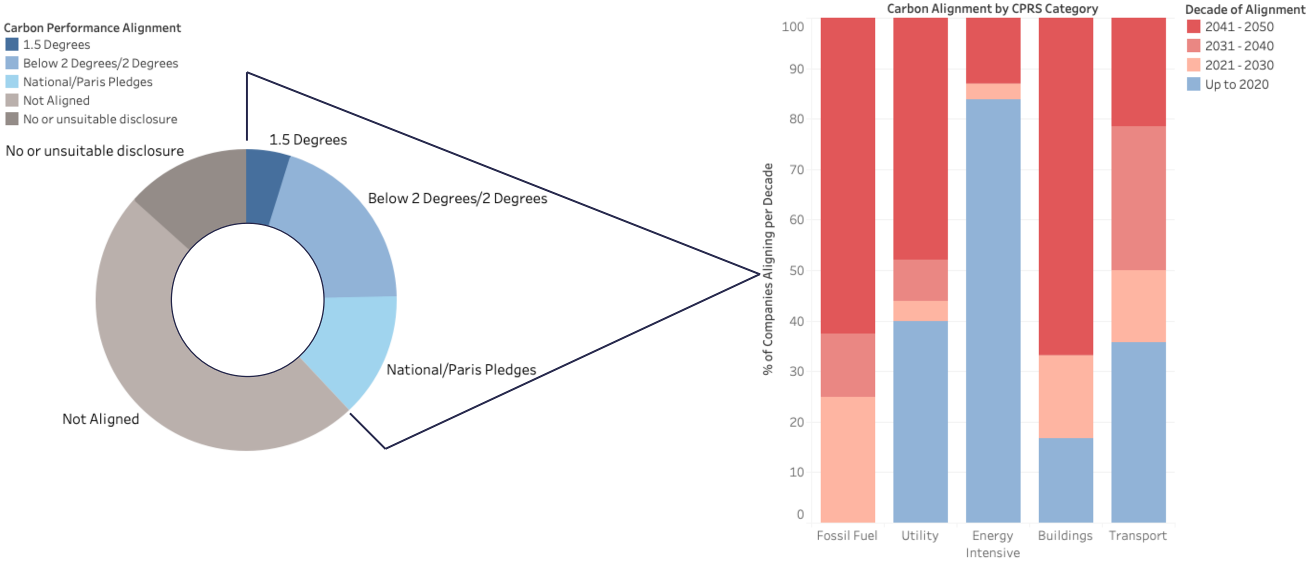
Assessment of Transition Risk in CPRS

- **Company Alignment to Climate Policy Pathway**
  - 181 out of 292 companies (62%) either do not offer suitable disclosure or are not aligned with a climate policy target.
    - With over 80% for 'Fossil Fuel' and 'Buildings' companies.



Assessment of Transition Risk in CPRS

- **Companies Decade of Alignment to Climate Target Pathway**
- 40 companies out of 111 (36%), will only become aligned after 2040.
- Over 50% of companies is all risk categories, except 'Energy Intensive', will become aligned after 2030.



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Designing a ‘transition-aligned’ Large Exposure Framework

Large Exposure Framework

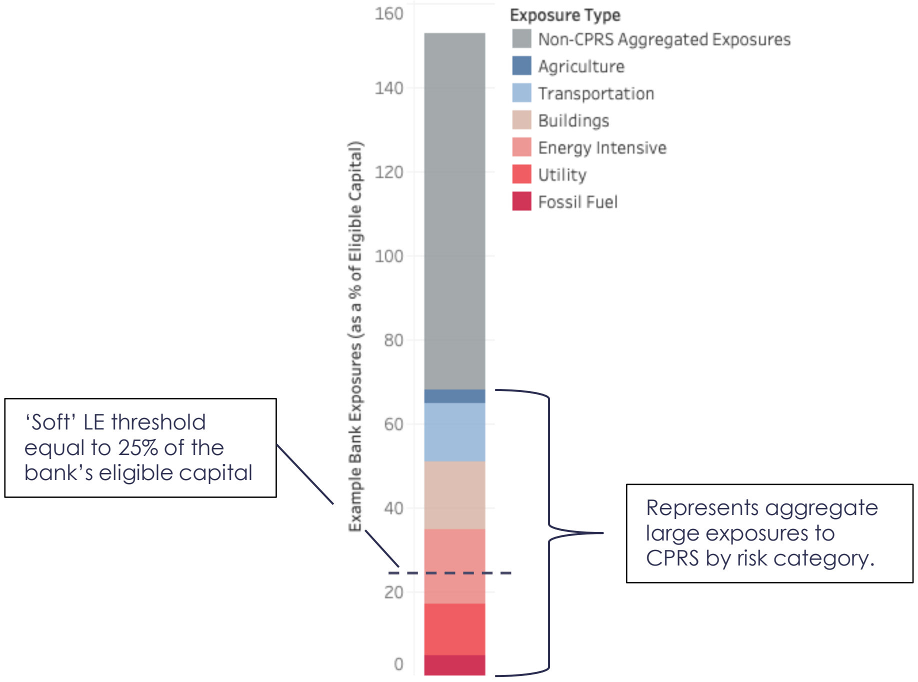
- **A large exposure (LE) is any exposure which exceeds 10% of a bank's eligible capital or a monetary value above €300m.**

- **Firms are not permitted to have exposures to a single counterparty (or group of connected counterparties (GCCs)) which exceeds 25% of their eligible capital. GCCs are determined on two conditions:**
    - (i) A control relationship
    - (ii) Economic interdependence

- **LE are reported with NACE codes, a classification system which identifies the economic sector and activity of the counterparty.**

‘Transition-Aligned Large Exposures Framework’

- **Maps large exposures to CPRS using NACE** to measure transition risk.
- **Banks are subject to LE thresholds of aggregate exposures to CPRS,** equivalent to 25% of eligible capital.
- **If the ‘soft’ thresholds is exceeded, banks are subject to a disclosure regime.**



Disclosure Regime

Firms in excess of 25% aggregate exposure to CPRS would be required to submit a 'Transition Strategy'.

1. Identification of Exposure to Main Climate-related Risks/Scenarios
2. Projection of Portfolio Exposure Alignment to Climate Policy Targets
3. A Forward-Looking Strategy to Mitigate Risks through Portfolio Exposure

Additional Supervisory Measures

i. **Climate Awareness Course** – senior management within the bank required to undergo a climate risk awareness course.

ii. **Structural changes** – changes to board composition, limitations placed on capital distributions, required hiring of climate risk experts.

iii. **Capital surcharge** – implemented through Pillar 2b (2G).

The use of a capital surcharge should be viewed a final resort for consistent inadequate management and disclosure of climate-related risks.

Policy Rationale, Considerations, Next Steps, and Policy Calibration

Rationale for Using the Large Exposures Framework

- **Necessary trade-off between prudential rigour to mitigate risk and the burdensomeness of requirements – cost of policy impact needs to be considered.**

- **There are two reasons why large exposures are selected for this policy:**
  - (i) Conventional large exposures have potential implications for financial stability; therefore, large exposures with unobserved climate risk pose a greater threat to financial stability.
  - (ii) Transition-sensitive sectors are typically concentrated by a small number of companies. Hence, most companies with potential transition risk are likely to be captured by the Large Exposure Framework.

Policy Strengths

- **Qualitative-based, forward-looking assessment –** overcomes the challenges of quantifying climate risk.
- **Intra-industry differences** – corporate-level assessment
- **Incorporating data into supervisory judgement –** banks' data collection practices on climate data included in assessment.
- **Supervisory measures based on disclosure –** the capital buffer offers supervisory tools for inadequate disclosure.

Policy Considerations

- **Green Risks –** the inclusion of green risks may be seen to undermine support for the transition to a net-zero economy.

- **The Policy Impact and Endogeneity of Climate Risk –** the adoption of policy to mitigate transition risk may cause the materialisation of transition risk.

- **’Soft’ threshold versus ‘Hard’ Limit –** a soft threshold may be an insufficient deterrent to encourage banks to incorporate transition risk into their business model.

Next Steps and Policy Calibration

1. Understand Exposure

- Determine banks’ exposure to transition-sensitive sectors in their large exposures.
- Estimate the costs and feasibility for companies to transition.
- Examine exposure in banks’ non-large exposures.

2. Build Capacity

- Improve sector identification reporting for accurate identification of CPRS.
- Hire ‘sector experts’ within the supervisory authority.

3. Develop Supervisory Tools

I. Climate Awareness Course

II. Change in board composition, risk management, restrictions on capital distributions

III. Capital Surcharge - through Pillar 2b (2G)

Thank you

Thank you for taking the time to listen to our presentation. Please get in touch if you have further questions.

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