KIRTANE & PANDIT

CLIMATE CHANGE RISK AND BANKING INDUSTRY

BRIEF

The surface temperature of the Earth has risen at a record pace in recent decades, creating risks to life, ecosystems, and economies. Climate science tells us that further warming is unavoidable over the next decade, and probably after that as well. In this uncertain environment, banks must act on two fronts: they need both to manage their own financial exposures and to help finance a green agenda, which will be critical to mitigate the impact of global warming. An imperative in both cases is excellent climate-risk management.

Regulation increasingly requires banks to manage climate risk. Some have made a start, but many must still formulate strategies, build their capabilities, and create risk-management frameworks. The imperative now is to act decisively and with conviction, so effective climate-risk management will be an essential skill set in the years ahead.

CLIMATE CHANGE AND BANKING

Environmental, social, and governance (ESG) issues as well as their associated opportunities and risks are becoming more and more relevant for financial institutions. For banks, sustainability is not just an ethical, but may soon enough also become an economic and existential question generating a new type of risk ESG risk. Banks ought to approach ESG risks in a holistic fashion when embedding them into their risk management frameworks. This process includes adjusting business and risk strategies and corresponding risk appetite statements, making sure roles and responsibilities are fully transparent throughout all three lines of defence. While ESG risk is not a fully stand-alone risk type, it exerts influence on financial and non-financial risks present in a bank to varying degrees. Hence, risk management methods and processes must be amended, considering the complex cause-effect-relationships across risk types.

Besides embedding ESG into risk frameworks, banks need to consider related issues in product design, pricing and sales decisions. Also, an appropriate consideration of ESG risks in a wide range of change processes is of vital importance for fostering profitability.

The regulators, rating agencies and other parties around the world are taking a keen interest in the topic, leading to increasing requirements and reporting needs. This constant flow of new regulations is bringing extensive compliance challenges for banks. Sustainability is expected to affect banks along their entire value chains both from strategic and operational.

TRENDS IN ASIA REGION

Integration of ESG into bank-wide ERM and governance frameworks is the first major step that institutions will need to take. The board of directors and senior management will need to set the tone from the top to start the integration process. Regulators in Asia have turned up the heat recently on ESG and climate change, demanding banks meet tight deadlines with initial roll-outs on progress reporting and stress testing. In May 2020 the Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC) established the Green and Sustainable Finance Cross-Agency Steering Group. The HKMA is full steam ahead with its green banking initiatives and has released a number of detailed guidelines and reporting templates to the industry. These guidelines are excellent resources to understanding the future policy direction and supervisory expectations in Hong Kong and Asia. The guidelines have laid out 9 guiding principles for managing the risk and opportunities brought by climate change.

1. Board Accountability
2. Climate Strategy Development
3. Strategic Formulation Process
4. Climate Risk Implementation
5. Risk Identification
6. Risk Measurement
7. Risk Monitoring & Reporting
8. Risk Exposure Controls and Mitigation
9. Disclosure

References: 1.McKinsey (June 2020) Banking imperatives for managing climate risk 2. KPMG (2021), ESG Risks in Bank

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We place our values, standards and ethics very high, in every work we do !

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