CLIMATE RISKS

On 21 April 2022, Toronto Centre convened a meeting of central bank governors and heads of supervision authorities from developing and developed countries to explore how international standard setters and national authorities are responding to the impact of climate-related risks on the financial system.

This was the second roundtable discussion hosted by Toronto Centre on this important subject. At the first roundtable, in October 2021, the discussion focused on how supervisory authorities and central banks have responded to climate-related risks by developing their understanding of the impact of climate change on their countries and on their financial sectors; assessing how climate-related risks relate to their mandates and objectives, including for financial stability and financial inclusion; and discussing climate-related risks with financial institutions and other stakeholders.[1]

Babak Abbaszadeh, CEO of Toronto Centre, welcomed the participants, outlined the objectives of the discussion, and thanked funders for their support of the Centre's mission. Babak noted that this second climate risk roundtable would continue the discussion of the role of central banks and financial supervisors (across all sectors) in responding to climate-related risks, and highlighted the Toronto Centre Climate Risk Toolkit for Financial Supervisors, published in September last year.[2]

Babak also observed that the invasion of Ukraine had heightened attention on energy security, in Europe and elsewhere, and may accelerate the attempts by governments to transition to low carbon economies. However, meeting the Paris Agreement climate change targets would remain a massive challenge.

The discussion was moderated by Nathalie Aufauvre (Director General, Financial Stability and Operations, Banque de France) and led by Sabine Mauderer (Member of the Executive Board of the Deutsche Bundesbank; and Vice-Chair of The Network of Central Banks and Supervisors for Greening the Financial System (NGFS)) and Kevin Stiroh (Senior Advisor, Division of Supervision and Regulation, Federal Reserve Board, and Co-Chair of the Basel Committee Task Force on Climate-Related Financial Risks (TFCR)). Kevin Stiroh participated in his capacity as Co-Chair of the TFCR.

The discussion focused on:

- The changing nature of climate-related risks.
- The "public good" collection and sharing of data, analysis, scenarios, good practice, principles and guidance by international organizations such as the Basel Committee, the International Association of Insurance Supervisors (IAIS), and The Network of Central Banks and Supervisors for Greening the Financial System (NGFS) The further work being undertaken in areas such as risk management in financial institutions and disclosures by corporates.

[1] The record of proceedings of the first roundtable can be found at: https://www.torontocentre.org/Files/NewsResources/11-4-2021/Roundtable%20discussion%20proceedings%20October%202021.pdf
[2] The Toronto Centre Toolkit can be found at: https://res.torontocentre.org/guidedocs/Climate%20Risk%20Toolkit.pdf

RECORD OF PROCEEDINGS[3]

Climate-related risks

The March 2022 IPCC report[4] had reinforced the scale and global nature of the challenges posed by climate change, and that there was very little time left to act. This highlighted the likelihood that policy responses by governments might be "too little, too late" – governments were constrained in moving quickly because there were not sufficient alternatives to fossil fuels in many countries, both developed and developing. As a result, the physical climate-related risks were increasing, while the transition risks were delayed but were also likely to be greater once governments made decisive interventions to scale back fossil fuel production and usage.

The Russian invasion of Ukraine was a major new geopolitical development. The immediate response in some countries had been a move back to domestic coal, oil and gas production by turning on new supplies and not scaling back existing production. If this continued it would accentuate the increase in both physical and (eventual) transition risks. However, there is also the prospect that seeking energy security in the form of independence from fossil fuels could accelerate the process of shifting to renewable energy sources.

The transition paths to a low carbon world economy have therefore become even more complicated and uncertain.

Participants discussed the role of climate adaptation policies and biodiversity (nature-related) risks, and noted the work of the NGFS to understand better the impact on financial risks. The cross-border impact of the disruption to the production and supply lines of Ukrainian wheat was a further example of nature-related risks, in addition to the nature-related risks arising from climate change.

These are clearly complicated and difficult issues that are not easily captured in traditional models, not least because of data issues and non-linearities. It is also difficult to identify appropriate policy responses. Further work is required on the transmission channels to financial risks and on the assessment of policy responses.

There are also impacts on central banks and monetary policy - what is the appropriate monetary policy response to external shocks such as rising inflation as a result of wars, pandemics and climate change? Will increasing interest rates suffice, or are other tools required both to control inflation and to manage expectations?

The only certainty here is that from a risk management perspective, financial institutions need to build robust approaches to these deep uncertainties and prepare for the occurrence of tail events, even if these events are not the central forecast.

Risk management

The Basel Committee published two analytical reports in 2021 on climate-related financial risks. The first focused on climate-related risk drivers and their transmission channels, exploring how climate-related financial risks arise and affect both banks and the banking system.[5] The second provided an overview of conceptual issues related to climate-related

---

[3] The discussion was conducted under the Chatham House rule – the themes reported here reflect the sense of the discussion but do not attribute observations to individual speakers.

[4] Climate Change 2022: Impacts, Adaptation and Vulnerability. https://www.ipcc.ch/report/ar6/wg2/

[5] Climate-related risk drivers and their transmission channels. https://www.bis.org/bcbs/publ/d517.pdf

financial risk measurement, and described banks' and supervisors' current and emerging practices in this area.[6]

Taken together, the reports concluded that climate-related risk drivers can be captured in traditional financial risk categories such as credit, liquidity, market and operational risks. For example, the location of a financial institution's head office, back-up centre and branches may generate operational risks relating to business continuity and the resilience of the institution's operations.

But while this is conceptually clear, additional work is needed to connect climate risk drivers to financial institutions' exposures and to estimate such risks reliably. While a range of methodologies is currently in use or being developed, challenges remain in the estimation process, including the specification of the transmission channels, data gaps, and uncertainty associated with the long-term nature and uncertain path of climate change.

This is further complicated by the uncertain indirect effects of climate-related risks and government policy actions on behaviours, prices, and the economy; by how the price and availability of insurance, new products, and hedging may shift risks around the financial system; and by the different impacts across different jurisdictions, different sectors of the economy, different corporates and different financial institutions.

As these challenges are addressed, the ability of financial institutions to estimate and effectively manage climate-related financial risks should improve.

Building on this analytical work, the Basel Committee will investigate the extent to which climate-related financial risks can be addressed within the existing Basel Framework, identify potential gaps in the current framework, and consider possible measures to address them.

Similarly, the IAIS has been collecting data on climate-related exposures, beginning with asset and investment exposures but expanding this year into climate-related underwriting risks.

The Basel Committee also issued last year a public consultation on high-level principles for the effective management of climate-related financial risks, covering areas such as governance, risk appetite, controls, and data.[7] The principles seek to achieve a balance in providing a common baseline for internationally active banks and supervisors while retaining sufficient flexibility, given the evolving practices in this area and the heterogeneity of the mandates of supervisory authorities.

Many national authorities have published their own national guidelines, which reflect national circumstances while also being consistent with the high-level principles on which the Basel Committee is consulting. And some national supervisory authorities and central banks with relevant mandates are already encouraging "green" financing, either through lending targets for banks or through the assets held by the central bank.

All countries are on a steep part of the learning curve and can learn from the sharing of knowledge on good practices and lessons learned. The Basel Committee, IAIS and NGFS are actively sharing as much information as possible to assist with global capacity building on climate-related risks.

---

[6] Climate-related financial risks – measurement methodologies. https://www.bis.org/bcbs/publ/d518.pdf

[7] Principles for the effective management and supervision of climate-related financial risks. https://www.bis.org/bcbs/publ/d530.pdf

Disclosure

Greenwashing is a concern for many stakeholders, including individual investors, relating not only to the trust of investors in ESG labelling but also to how investment managers can manage the risks to themselves. Disclosure is therefore a key issue.

Participants noted many taxonomies have emerged or are being developed, various ESG labels, and different metrics and data used by private rating agencies. This poses challenges to comparability and interoperability across and within sectors and jurisdictions. For example, taxonomies based on industries may miss important differences across individual corporates (one tricky issue here is how to classify fossil fuel producers that are diversifying into renewables), while even at the individual company level firms are always changing so classifications may have to adjust accordingly. There may also be scope to reflect a wider range of outcomes ("light green" and "light brown") and to incentivize firms to choose paths towards net-zero emissions.

Progress is being made to improve the consistency, comparability, and reliability of sustainability reporting. This was taken forward first by the FSB Task Force on Climate-Related Financial Disclosures (TCFD), and more recently by the International Sustainability Standards Board (ISSB), which is seeking to establish global disclosure standards that provide investors and other capital market participants with information about companies' sustainability-related risks to help them make informed decisions. Some regional and national authorities may build further on this global approach to reflect different circumstances.

Conclusion

Participants noted that a considerable amount of information and analysis had usefully been made available by international organizations such as the Basel Committee, IAIS and NGFS. All of this should be helpful for national authorities wanting to make progress in assessing and responding to climate-related risks. However, more work would be required to reflect the changing nature of climate-related risks; the consideration of nature-related risks; the optimal and proportional requirements on financial institutions to identify, measure, control and govern these risks; and the disclosures required to underpin financial flows that are compatible with a sustainable future.

ABOUT TORONTO CENTRE

Toronto Centre for Global Leadership in Financial Supervision (Toronto Centre) is an independent not-for-profit organization that promotes financial stability and access to financial services globally by providing training that strengthens the capacity of financial sector regulators and supervisors, particularly in emerging markets and low-income countries. We believe that for countries to thrive, their financial systems must be stable and inclusive. By helping to build these economic foundations, our mission supports sustainable growth and job creation, and helps to reduce poverty. Since 1998, we have trained more than 16,000 supervisors and regulators from over 190 countries and territories. Toronto Centre is supported by Global Affairs Canada, the IMF, Swedish Sida, Jersey Overseas Aid, Comic Relief and United States Agency for International Development (USAID) and other valuable international partners such as the World Bank.

For more information, please visit www.torontocentre.org