

"Climate Change Risk Management in Banks- the next paradigm"

By Ms. Saloni Ramakrishna

Practitioner's Note – Part 5 - "Going Forward."

Finding the right balance of approach to climate-related financial risks

Decarbonization is the global trend. However, world is a dynamic place with newer realities/ challenges adding to its canvas. The worsening situation in Ukraine has caused the price of natural gas to skyrocket, and some are worried about a "rollback" of decarbonization. Goodnews is that the movement to promote decarbonization appears to be rather accelerating.

For example, in the first half of 2022, we have seen more regulatory/supervisory/disclosure guidance on climate-related risk issued by international organizations (FSB, BCBS, ISSB), European authorities, and U.S. authorities than ever before. Ms. Saloni Ramakrishna, deftly, traces and features the highlights of the important guidelines across the book and their stated roadmaps in Part five, the "Going Forward" section.

There is a shift from the conventional "high-level" content to specific practices from the practical perspective of financial institutions. Among them, the report published by NGFS analyzed the degree to which climate-related risks can be recognized quantitatively, implying the future bank capital regulation vis-à-vis climate-related risk. There have also been many discussions in the macro-prudential area, including the stress testing focusing on climate-related risk conducted by the BOE and the ECB and the ECB/ESRB report on the challenges of addressing climate change risk from a macroprudential perspective.

At the same time, as Ms. Saloni Ramakrishna rightly points out, there are tremendous challenges to overcome before attaining the net-zero GHG target by 2050 through banks' cooperation. For banks that have to measure its scope 3 GHG, collecting the data of GHG emissions of their clients is the primary issue. Depending on the external vendors' solution, which usually assumes a "structural model" could be an answer, but this should be supplemented by banks' analysis using their clients' financial data, such as the cost-to-sales sensitivity to oil price changes obtained by the "reduced-form model." Considering the diversity of each company's businesses producing GHG even with the highly granular industry classification, methodologies need to be developed to estimate individual company level's GHG footprint, including in the cases of SMEs.

Another fundamental issue is how to achieve a "just" transition. GFANZ has already pointed out potential conflicts with achieving other SDG/ESG targets, including reducing poverty. The challenge is to transition to a decarbonized society in a "just" way that minimizes these conflicts. In Japan, for example, with a time horizon of 30 years, we have other significantly essential issues such as "declining birthrate and aging society," "major earthquakes," and "fiscal sustainability." Focusing only on climate change while ignoring other important issues may lead to biases in policy responses (misallocation of policy implementation resources) and unexpected policy outcomes.

Similarly, we should pay due attention to the risk that the climate change response could invite unintended consequences through its correlation with other issues.

A typical example would be increased reliance on nuclear power generation as a result of aiming to reduce GHG as part of the climate change response. Under current technological constraints, there appears to be a trade-off between climate-related risk and the risk of nuclear power plant dependence. Suppose the society's appetite for the risk associated with nuclear power plant dependence is not thoroughly assessed before proceeding with climate change responses. In that case, the result may be a biased policy outcome that ignores the possible low appetite for the nuke risks.

With all the above issues in mind, my top three suggestions for financial institutions are:

1. Focusing on GHG emissions of individual clients for sharing and enacting the same passion for decarbonization rather than focusing on estimating industry based GHG emissions just for reporting purposes.
2. Becoming sensitive to all SDG (Sustainable Development Goals) related serious risk events which are likely to be materialized over the coming 30 years and apply similar risk management methodologies developed for climate-related risk to them.
3. Becoming aware of the right balance between climate-related risk and others.

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