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WHAT IS CLIMATE RISK AND WHY DOES IT MATTER TO FINANCIAL SERVICES?

Since 2015, climate risk has moved from being a long-term horizon risk, discussed fleetingly in firms, to become one of the highest priority risks on the supervisory agenda. Climate risk crystallizes because of climate change and its impact on natural and human systems. It can be broken down into three sub-risks:

1. **physical risk**, from climate change affecting our economy and society directly,

2. **transition risk**, related to moving towards a greener economy and

3. **liability risk** where banks may find themselves liable to pay compensation due to physical and transition risk related losses[1].

SO WHY IS IT IMPORTANT TO FINANCIAL SERVICES?

In addition to the impact climate change has on broader society, there is also a material impact on the financial sector. The cost of weather-related events to the insurance industry in 2019 was estimated to be $350 billion[2]. This compares with an inflation-adjusted value of $60 billion in 1980, meaning there has been a 480% increase in real costs over a 40-year period. Weather-related events leading to insurance claims have also increased over threefold in this period from 250 in 1980 to 820 in 2019. Although banks are less directly impacted than insurers, they are undoubtedly impacted by weather events that lower the ability and probability of borrowers repaying. For instance, in the US, were sea levels to rise by the currently predicted six feet by 2100 that would wipe $900 billion off the value of housing stocks there[3].

Transition Costs

The costs above relate to the physical risk aspect of climate risk, so the full economic cost (think transition and liability costs) to the financial services industry is likely to be much greater. On the plus side, with improvements in technology, the cost of transitioning to a net-zero economy continues to fall. According to the latest UK Climate Change Committee report, full transition costs are expected to only be 0.5% of 2050 GDP, down from 1-2% of GDP for an 80 percent transition in 1990[4]. Not only do climate reducing investments decrease costs, but companies can also expect positive returns. For instance, installing solar panels reduces energy costs with surplus energy being sold on.

Litigation Cases

However, where banks may see a significant rise in exposure is their liability risk. Quantifying this is particularly challenging, but a useful proxy is to see how many climate change cases are pending in the courts. There are currently over 1,400 cases pending in the US and nearly 450 pending elsewhere in the world[5]. Although many of these are being brought against governments it is also not too far-fetched to think that banks can and will be caught up in the litigation.

Regulation

On the regulatory front, there is great disparity by geographical jurisdiction, but we are seeing a clear trend towards national and supranational regulators taking an ever more interested view in sustainability. The EU's Sustainable Finance Disclosure Regulation (SFDR) came into effect in March 2021, which for the first time formalizes the integration and consideration of sustainability risks into internal processes[6]. The UK, via Her Majesty's Treasury (HMT), published its roadmap for climate related disclosures in November 2020, which will see all large companies in the UK required to produce mandatory reporting by 2025[7].

The EU and UK are at the forefront of the regulatory charge but are being swiftly followed by a range of countries including New Zealand, Hong Kong, Canada, and a recommitted United States. Renewed focus at forums such as the G7, G20 and COP26 is expected to accelerate regulation and drive more onerous sustainability requirements in the coming months and years.

ESG Agenda

Environmental, Social, and Governance (ESG) is a growing agenda which we have observed many firms progressively applying these non-financial factors as part of their analysis process to identify material risks and growth opportunities.

> *"Please make no mistake – climate change is the biggest threat to security that modern humans have ever faced."*
>
> Sir David Attenborough (2021)[8]

As more pressure mounts on governments to enforce social responsibility, ESG may begin to filter through to laws and regulations. In recent years, we have seen new laws such as GDPR, net-zero emissions targets and even social regulations such as the 'sugar tax' being enforced. The more obvious ESG related policy is around climate change which has moved to the forefront of many political agendas – ESG in Financial Services

HOW CAN THE FINANCIAL SERVICES SECTOR PREPARE NOW?

In 2020, our non-financial risk paper explored the challenges and made recommendations on what firms can do now to derive the most value from management of their non-financial risks[9]. Of most relevance from a climate risk perspective is how to manage your key risk exposures.

Banks and insurers should start by immediately incorporating climate risk into their risk management frameworks.
From Capco's experience of working on non-financial risk optimization, we may see indirect references to climate risk via their plans for a greener economy. However, it seems to be rare for climate risk to have a direct focus using embedded taxonomies and well-defined risk owners as the litmus test. Capco's own benchmarking exercise – Climate change – A looming problem for the world and now the banks – of 33 banks showed that risk management disclosures in climate reporting lagged other sections and require heightened focus moving forward.

Firms should also embrace technology that allows them to better simulate the effects of climate risk both on themselves, and their clients and customers, and enable them to make better decisions. For instance, if they are planning to open a new office, they must ask themselves, "How likely is this office going to be affected by an adverse climate event during its planned occupancy?" as well as considering its own operational emissions. Ahead of lending or investing, firms should strongly be considering the risk to their capital because of either physical or transition risks, a lens that to date has been widely underutilized.

HOW CAN CAPCO HELP?

Regardless of how far you are into your climate risk journey, Capco can support through a range of options:

- **Provide support in understanding your position in sector benchmarking vs best practice** – Based on your progress to date or proposed implementation plan, Capco can benchmark you against recommended peer group to determine where you rank against the eight components of our model Climate Risk Management Framework. The outputs will include a range of recommendations and approaches to enable you to achieve your desired maturity level.

- **Defining your target end-state and develop a roadmap to achieve this** – The desired quality of your climate risk management framework and linked disclosures will be driven by the maturity of the underlying components. Capco can support in performing a stock take of current climate-related initiatives and tools within your firm, and identifying any enhancements required for each area that will allow maturity in climate risk management.

- **Understanding data requirements and how to source these** – The deployment of your framework will ultimately succeed or fail depending on the access you have to useable relevant climate-related data. Capco can support in performing requirements gathering exercises, leading to a full gap analysis of the required data, allowing your bank to understand what it needs to develop to deliver complete and comprehensive climate risk management.

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ABOUT CAPCO

Capco is a global technology and management consultancy dedicated to the financial services industry. Our professionals combine innovative thinking with unrivalled industry knowledge to offer our clients consulting expertise, complex technology and package integration, transformation delivery, and managed services, to move their organizations forward.

Through our collaborative and efficient approach, we help our clients successfully innovate, increase revenue, manage risk and regulatory change, reduce costs, and enhance controls. We specialize primarily in banking, capital markets, wealth and asset management and insurance. We also have an energy consulting practice in the US. We serve our clients from offices in leading financial centers across the Americas, Europe, and Asia Pacific.

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