CLIMATE-RELATED FINANCIAL RISK IN BANKING

MONOCLE

1 ABOUT MONOCLE

Monocle is an independent, results-focused management consulting firm specialising in banking and insurance with two decades of experience working alongside industry leading companies around the world. With offices in London, Amsterdam, Cape Town and Johannesburg we service our clients across the United Kingdom, Europe, Scandinavia, Asia, South Africa and much of Sub – Saharan Africa.

At the heart of climate-related financial risk (CRFR) is effective data management to enable various downstream processes. For greater insights into this topic, download and read our "Climate-related Financial Risk in Banking" insights paper.

2 OVERVIEW OF CLIMATE-RELATED FINANCIAL RISK

In its "Global Risks Report 2021", the World Economic Forum found that environmental risk is the most likely risk to impact the global economy. While the carbon footprint of the financial services industry is relatively small compared to others, banking, insurance and asset management are nonetheless liable for their contribution to "financed emissions" through their activities, which ultimately support carbon-intensive industries.

The release of the **Task Force on Climate-related Financial Disclosure** (TCFD) **report** in 2017 provided recommendations and principles for the disclosure of climate-related governance, strategy and risk management, as well as metrics and targets. The Report has become the foundation of CRFR management policies around the globe.

Risk Management	Metrics and Targets
Disclose how the organisation identifies, assesses, and manages climate-related risks.	Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities, where such information is material.
Governance	**Strategy**
Disclose the organisation's governance around climate-related risks and opportunities.	Disclose the actual and potential impacts of climate-related risks and opportunities on the organisation's business, strategy, and financial planning, where such information is material.

Financial services institutions are facing increased policy and stakeholder pressure to embed climate-related risk management in their operations. This is part of a larger push towards environmental, social and corporate governance (ESG) awareness to:

- **Ensure their balance sheets are protected from climate-related disruptions**

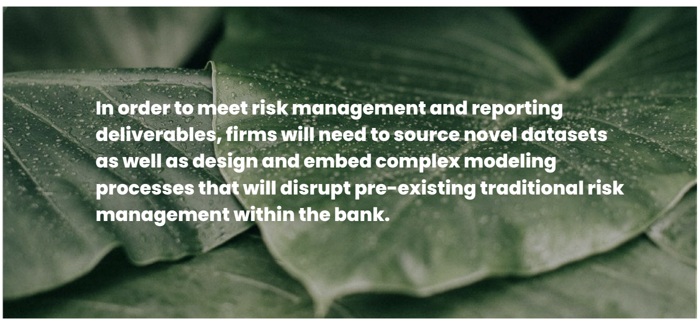
  Firms will need to ensure they are managing the two risk drivers – physical and transitional - that will influence their existing risk types:

  - Physical Risk: The risk directly attributed to changing and extreme weather/climate patterns that impact economies.
  - Transitional Risk: The risk arising from the shift towards an environmentally sustainable and net-zero carbon emissions global economy.

- **Enhance the degree to which their services and products support the green economy.**

3 KEY DATES & DELIVERABLES

2017	TCFD	Voluntary CRFR disclosure recommendations report released by the TCFD. Most regulatory policy is drafted to align with the report.
2020		European Commission releases the EU Taxonomy, enforcing standardised climate terminology while using the data reporting requirements of the Non-Financial Reporting Directive (NFRD).
		European Central Bank releases "Guide on Climate-related and Environmental Risks", detailing expectation on banks' CRFR management and disclosure.
2021		Bank of England's Supervisory Statement 3/19 requiring full CRFR embedment in governance, strategy, risk management, scenario analysis and disclosure.
		Bank of England's Biennial Exploratory Scenario exercise begins to stress test the resilience of the UK financial system across large banks and insurers.
Upcoming		European Banking Authority consults on EU Pillar 3 reporting, stress testing and scenario analysis.
N/A		South Africa has yet to develop any explicit policy around CRFR management. South African banks must, however, comply with the ESG requirements of the Companies Act and King IV, if listed on the JSE.



4 KEY CHALLENGES

Climate-related financial risk is in its infancy, leaving financial services leaders with difficult decisions to make in terms of understanding what is required of them and how to implement these requirements. Challenges include:

- Lack of standardisation and data quality of underlying data across multiple jurisdictions and sectors
- Climate-related data gaps that are difficult to remediate due to high level of granularity, availability at counterparty and sector levels, as well as non-standard formats
- Development of data models and infrastructure to support new datasets including climate event risk drivers, their climate-adjusted economic risk drivers, exposure vulnerability data as well as additional financial data
- Integration of climate-related risk into existing risk management processes and frameworks for credit, liquidity, market and operations risk
- Lack of regulatory guidance and rapidly changing regulatory environment
- Uncertainty around scenario analysis and stress testing assumptions including 30-year timeframes, non-linear trends and poor understanding of transmission channels and interconnections.

MONOCLE'S APPROACH

The practice of climate-related risk management is relatively new and challenging; however, Monocle understands the core data and process principle components. As our clients begin to embed climate-related financial risk management within their operations, we are well-equipped to analyse firms' data landscapes to identify data gaps and remedy these gaps. Our deep understanding of and extensive experience with data management - garnered through our work on multiple projects related to BCBS 239 and the principles of effective data aggregation and reporting - ensure that we can design and build robust regulatory reporting solutions to meet all disclosure requirements.

We provide support for the embedment of processes such as scenario planning, stress testing and reporting, as well as the array of risk management practices employed by financial services institutions, from climate-adjusted credit score cards, to heat map risk and threshold monitoring.

Our experience in risk modelling and integrated stress testing across all the major risk types ensures that we are well positioned to assist our clients in iteratively developing their modelling capabilities while overcoming the challenges of uncertain assumptions, limited data and integration with the wider risk framework.

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