



Analyses et synthèses

Climate change: which risks for banks and insurers?

The Autorité de contrôle prudentiel et de résolution (ACPR) publishes today two issues of “Analyses et Synthèses” devoted respectively to how French banks and insurers take into account and manage climate change risks.

The challenges related to climate change are considerable and the expected contribution of the financial sector to the financing of the transition to a low carbon economy crucial. In this context, **this joint publication has two main objectives**, which form part of both a comprehensive strategy and a commitment by the Banque de France and the ACPR.

The first objective is to put in place favourable financial conditions aiming at fostering an orderly transition to a balanced and sustainable economy so as to fight against global warming. This involves, in particular, the need for better information on climate-risks exposures to support informed investment, lending, and insurance underwriting. This enhanced transparency will help produce a smarter and more efficient allocation of resources and capital.

The second objective is to protect financial institutions against the detrimental effects of climate change by making sure they have clearly identified the relevant risks and put in place appropriate governance structures to efficiently manage them from a financial stability standpoint.

With this in mind, this joint publication firstly assesses the implementation of the provisions of the Energy Transition Act for Green Growth (LTE – *Loi sur la transition énergétique pour la croissance verte*). A first state of play was published under the aegis of the Treasury in March 2017,¹ based on data collected from banking institutions in 2015.

In order to increase transparency, for both customers and investors, listed companies and financial institutions are requested to specify, in their regular risk reports, their analysis of the financial risks related to climate change and the measures taken to reduce them.

For the companies concerned by the publication of a report on Corporate Social Responsibility (CSR), the text provides for publications on waste management, sustainable use of resources and significant items of greenhouse gas emissions. Institutional investors and asset managers have to communicate, in their annual report and to subscribers, on the climate risk of their portfolios. In addition, they have to assess the green part of their investments and to define their low-carbon strategy since 2016. More specifically for banks, the law adds climate change risks to the existing list of risks subject to prudential supervision, mandating they be “highlighted in the context of regular stress tests.”

This joint publication is also a contribution to the work of the Network of Central Banks and Supervisors for Greening the Financial System (NGFS) launched by the Banque de France at the *One Planet Summit* hosted by the President of the Republic in December 2017 in Paris.

¹ Assessing risks to climate change in the banking sector. <https://www.tresor.economie.gouv.fr/Ressources/File/433386>

The network brings together, to date, around thirty central banks and supervisory authorities across five continents, as well as five observers from European and international institutions. In particular, the purpose of the network is to develop and diffuse best practices on governance and climate risk management and, as a coalition of willing, to think how central banks and supervisors could enhance the role of the financial system for greening the economy.

As a member of this network, the ACPR takes an active part in the reflections on climate risk supervision and the identification of macroeconomic and financial channels through which these risks could affect the financial system, in particular the banking and insurance sectors. **More specifically, these reflections aim at developing risk measurement and assessment tools on the balance sheet of financial institutions, with the goal of implementing climate change risk stress tests.**

The methodology implemented in the two studies published today relies on a data collection and questionnaires sent to the main French banking groups and insurers over summer 2018, completed by bilateral meetings focusing on the governance and the management of climate-change related risks. Environmental-related risks and the risks harming biodiversity are not addressed in these publications, which focus on the financial stability perspective.

Banks and insurance companies' exposures are based on the data provided by these institutions, generally at a relatively low level of granularity with respect to sectors or locations. This makes it difficult to draw definitive conclusions about the underlying risks and the extent to which institutions are positively contributing to the transition to a low carbon economy. For instance, an increase in the exposures to a sector generating large amounts of greenhouse gas should not necessarily be interpreted as negative if the funding increases energy efficiency or positively contributes to the fight against global warming.

Four main lessons can be learned from these two studies.

First, there is significant progress in the governance of climate change risks. Beyond announcements about divestment policies in greenhouse gas-producing sectors, banks and insurance companies have generally adopted strategies referring to the Paris Agreement. Some also have been providing regular information to the highest decision-making bodies of these institutions on climate risk exposures. There is also a gradual integration of this risk into the usual financial risk management processes, beyond

merely the CSR dimension that prevailed in 2015 and where climate risk was mainly perceived by banking institutions as reputational risk. The progress observed is, however, heterogeneous and we note a lack of operational adaptation of business strategies at the level of business lines.

With regard to the climate change risks, we observe:

- **modest progress in the apprehension of the physical risk**, i.e., the risks associated with the physical effects of climate change (e.g., drought, floods, extreme climate events...), to which, admittedly, French banks and insurers are little exposed: indeed, their exposures are generally located in areas that are not considered greatly vulnerable to current climate change scenarios, mostly in France – where there exists an effective regime to deal with natural catastrophes – and mainly in the European Union, with relatively small exposures in the United States and Asia.

In this area, insurers, beyond risks on the asset side of their balance sheets, have developed very fine measures for the location of insured persons and goods for the purpose of their business. In this sector, the risks associated with the increase of the frequency and cost of extreme weather events have direct consequences on the pricing of insurance policies and could eventually raise the issue of insurability of certain risks, with possible implications for public policies and financial conditions (increase in risk premia or negative impact on collateral valuations). By contrast, data collected by banks generally appear to be insufficiently granular, in particular with regard to their geographical exposures;

- **significant progress in analysing transition risk**, i.e., the risk associated to the transition to a low carbon economy entailing policy, legal, and technology or market changes to address mitigation and adaptation requirements to climate change. This progress reflects a more significant exposure of French financial institutions. For example, in the case of banks, the share of the 20 most carbon-intensive sectors represents 12.2% of net outstandings exposed to credit risk in 2017, slightly decreasing compared with 2015, while around 10% of the investments of French insurers would be invested in transition risk sectors (sectors producing or consuming fossil fuels, electricity or gas);

French institutions continue to develop the tools to analyse this risk, with, for some of them, first sensitivity measures of portfolios. The experience of insurers in managing climate risk is more advanced on this point, with the regular use of severe stress tests. However, the horizon for these tests is generally very short (5 years on average), far below

the assumed horizon for materialising transition risk (2030-2050), and the Environmental, Social and Governance criteria (ESG) used by insurers struggle to integrate a forward-looking perspective of this risk;

- **finally, the liability risk**, which corresponds to the damages a legal person would be required to pay in case it is deemed to be responsible for the consequences of global warming, **is not yet well analysed by French banking institutions and insurers**. This is unsatisfactory, given the increasing number of international remedies and the fact that this risk can also be a catalyst for transition risk. Banks and insurance are exposed to this risk: directly, if these institutions are deemed responsible for contributing to the consequences of climate change – even if this responsibility might be difficult to establish – and for the insurance sector that proposes legal protection contracts; indirectly, if the institution is exposed to corporates deemed responsible through counterparty risk channels, market risk and reputational risk.

These assessments confirm the relevance to pursue the ACPR's analytical and supervisory work so that the financial sector further takes into account these risks. Two working groups will be established with French institutions. The first one on the governance of climate-change related risks and the second one on risk metrics and scenarios analysis.