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New Research Suggests Ways for Banks and Regulators to Measure Climate-Related Risks

The Basel Committee on Banking Supervision's recent research on climate-related financial risks for banks offers a deeper understanding of potential impacts and strategies for incorporating climate risk effectively.

As questions around climate disclosures and increasing regulation continue to arise, it's important for firms to stay alert and ready to address change, from structural adjustments to financial metrics. Recently, the Basel Committee on Banking Supervision (BCBS) disclosed a set of new studies that were undertaken to assess the current landscape of climate-related financial risks for banks and the global banking system. The committee's goal was to offer banks and banking supervisors a deeper understanding of these risks and provide suggested methods for implementing climate into financial risk measurement.

This article takes a closer look at these reported findings, their impact on banks and what strategies to use to ensure firms are measuring and incorporating climate risk effectively.

Climate-Related Financial Risks in Banking

The committee's research team initially explored how climate-related risk drivers — such as physical risk or transition risk — arise, and how they impact banks and the banking system. The researchers concluded that financial institutions' existing risk categories are already sufficient to capture climate-related risk.

The impacts of climate-related regulation on credit risks for banks are now relatively well recognized. However, as of yet, there is still less recognition of other potential influences that climate can have on the banking system, such as market risk and how risk exposure varies according to geographic location and business model. To help close this gap, the research team recommends paying closer attention to how climate risk drivers feed into banking transmission channels, such as ripple effects from a bank's balance sheet and losses due to systemic concerns impacting linked entities, entire markets and wider financial systems.

Beyond laying out the state of play on the drivers of climate-related risks, BCBS also provides strategies bankers can use to help measure and incorporate climate risk. Up until now, this measurement has typically centered on near-term transition risks — such as the carbon intensity of portfolios — while neglecting other important factors of climate-related financial risk. Further, the main focus has been on assessing climate impact on credit risk, while overlooking other risk categories that also have the potential to impact banking. With more thorough engagement on potential market risk, as well as liquidity and operational risk, banks can construct increasingly robust and effective climate-related models and scenarios.

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Key Report Findings

The BCBS studies revealed a number of key findings that will likely help guide approaches to climate-related financial risk for banks, including:

- Current risk categories used by financial institutions (and reflected in the Basel Framework) are sufficient to incorporate climate-related risk, but implementation has been uneven.
- Little attention has been paid to how drivers of climate risk feed into banking transmission channels, causing potential broader financial risks.
- Climate-related financial risks have unique features that prevent easy incorporation into conventional risk management tools.
- There is excess focus on banks' near-term transition risk drivers to counterparty and portfolio exposures and not enough focus on climate-related market risk, liquidity risk and operational risk within overall assessments.
- Additional attention is needed for translating climate-related risks into robustly quantifiable financial risk, closing measurement gaps and developing standard methods to assess long-term risk.

This research is predicted to significantly influence central bank recommendations on climate-related financial risks and climate data appraisal going forward. BCBS is a forum for central bank governors and other top-level regulators to share information and coordinate on matters related to banking supervision. Encompassing participants from 28 jurisdictions, the committee is hosted by the Bank for International Settlements (BIS), which, for nearly a century, has promoted and facilitated global financial and monetary stability through undertakings like implementing the Bretton Woods agreements on currency convertibility, globalizing the financial system and establishing the Financial Stability Board.

The BCBS will build on this research to consider how climate-related financial risks can be addressed within the existing Basel Framework and how to address any gaps that may be identified. The committee will also undertake further work in climate-related regulatory, supervisory and disclosure elements for the banking system. This could include capital surcharges for banks to better reflect the risks, supervisory guidance, scenario analysis, disclosures or best practices for risk management.

Next Steps

Companies operating in the banking sector should consider how to properly size climate-related financial risks. While climate scenario analysis is an important step in this process, a broader recognition of climate impact will also be necessary to meet the goal of understanding possible effects on transmission channels and industry partners. Aon can assist financial institutions navigate emerging challenges presented by climate change by:

- Bringing together a suite of proprietary and third-party models to enable clients to better understand the implications of climate risk on their portfolio
- Helping firms adapt these models and data points to reflect counterparty default exposures linked to climate risk

- Delivering comprehensive insurance gap analysis and access to a full range of insurance solutions
- Navigating potential shareholder activism on climate risk
- Keeping boards up to date on emerging climate trends and other ESG risks and opportunities
- Helping with reporting and external messaging on climate-related topics

Organizations should seek out sufficiently granular data to capture all climate-related risk exposures and develop a robust range of scenarios for incorporating that data. Communicating and responding to changes in the climate-related risk landscape will require banks to take a multifaceted approach, allowing them to tailor to their firm's own attributes.

To learn more about upcoming regulations related to climate risks or to speak with a member of our rewards consulting group, please visit our boardroom hub or write to rewards-solutions@aon.com.

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