Blog

Mitigation of climate risks calls for new perspectives and cooperation

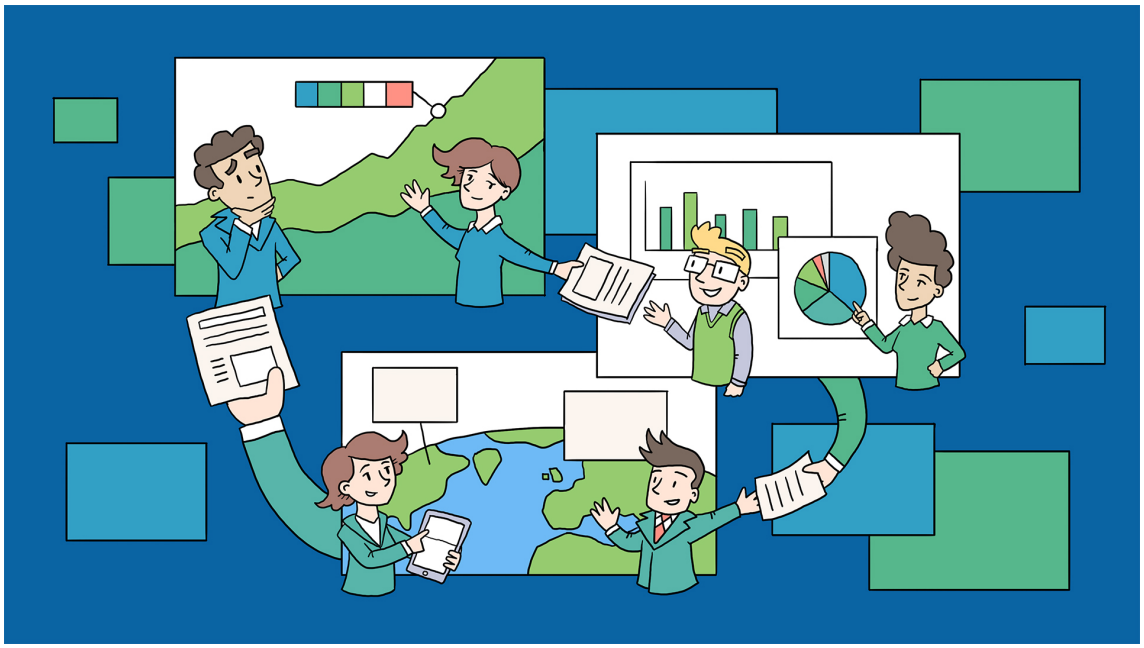
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Assessing the risks and costs arising from climate change – its effects, mitigation and, in the worst case, failure to mitigate – presents a major challenge for financial sector participants.



Assessing, modelling and pricing of risks is among the core activities of financial sector companies. The realisation of risks is always subject to uncertainty: the longer the time horizon for risk realisation, the harder it is to identify the risks and estimate their impacts. Financial sector participants are used to living with this uncertainty.

Assessing the risks and costs arising from climate change – its effects, mitigation and, in the worst

case, failure to mitigate – presents a major challenge for financial sector participants. Central banks and supervisors are no exception in this respect.

It is important that financial sector companies adequately consider climate risks in their activities. In my previous blog post (in Finnish), I discussed the two recognised risk types: physical risks, i.e. the direct economic losses from climate change; and transition risks, i.e. losses that arise when economic actors transition towards a low-carbon economy.

The Bank of Finland seeks to assess the scale of economic and financial market risks related to climate change from the perspective of financial stability. Collecting reliable statistical data and assessing the effects of climate scenarios on the financial markets are important in analysing climate risks. There is no common framework established yet for the assessment of these risks. One of the first steps could be to identify the key statistical data on climate and finance, the related data gaps and, especially, the linkages of the financial system with emission-intensive economic activities. In a recently published statistical review (in Finnish), Nea Tiililä and Antti Alakiuttu have made an attempt in this direction.

Although a fair amount of various climate data are already being reported, financial sector participants find it very challenging to combine this data with key financial indicators. Identifying interlinkages between the various players or the effects of value chains may be difficult. However, the lack of perfect information should not be a reason for inaction. Only a very few institutions have the resources to do everything by themselves. This is why the Bank of Finland is a member of the Network for Greening the Financial System (NGFS), a global forum formed by central banks and supervisors which brings together the best experts to analyse and develop alternative solutions for better risk management.

In April 2019, the NGFS published its first comprehensive report containing six recommendations[1] based on best practices for central banks, supervisors, policymakers and financial institutions. By complying with these recommendations, the aforementioned actors can both enhance their role in the greening of the financial system and manage their environment and climate-related risks.

The NGFS recommendations are:

- Integrating climate-related risks into financial stability monitoring and micro-supervision
- Integrating sustainability factors into own-portfolio management
- Bridging the data gaps
- Building awareness and intellectual capacity and encouraging technical assistance and

knowledge sharing

- Achieving robust and internationally consistent climate and environment-related disclosure
- Supporting the development of a taxonomy of economic activities.

The first four recommendations concern central banks' field of activities. As the transmission of climate risks to the macro economy is still unclear, it is important that central banks incorporate the physical and transition risks from climate change in their economic forecasts and financial stability analyses.

Data plays a crucial role in today's world. The third recommendation concerning the improvement of climate statistics and their usability calls for cooperation between central banks and other statistical data providers. Cooperation contributes to the availability of as comprehensive climate statistics as possible and the combination of these statistics with economic and financial data.

Systematic compliance with the NGFS recommendations would foster the preparedness of the whole financial system for climate change. Thorough preparedness would also reduce the probability of climate-based systemic risks. A functioning, reliable and stable financial system is pivotal for ensuring the financing of the significant investments required to mitigate climate change.

The domestic financial sector is actively striving to consider climate risks in its operations. Going forward, dialogue between the authorities – legislators, central banks and supervisors – and the financial sector will be increasingly important in building awareness and sharing best practices. The Bank of Finland and Ministry of Finance's joint conference on 30–31 October 2019 provides one of the fora for such dialogue. The conference, entitled 'Greener Finance for Sustainable Future', is already fully booked, but it will be live-streamed and the sessions can be watched online at:

- Day 1: 30 Oct 2019 (YouTube)
- Day 2: 31 Oct 2019 (YouTube).

Keywords

central banks, climate change, climate-related risks, financial stability, financial supervisory authorities, statistics