How banks can measure physical climate-related risks for EBA Pillar 3 compliance

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The impact of climate change on markets, public and private assets, as well as portfolios, continues to be a priority for banks navigating an evolving risk management landscape. Understanding how climate related risks can impact portfolios and assets is critical for effective portfolio management and compliance considerations. Regulatory requirements are demanding that banks identify, manage and disclose risk exposures tied to climate change.

This is the driving force behind EBA Pillar 3, a disclosure framework published by the European Banking Authority. In its latest update, finalized in June 2024, in-scope financial institutions are required to disclose their activities related to several sustainability risks including:

- Climate-related transition and physical risks
- Mitigating actions that support a transition to a low-carbon economy
- KPIs on environmentally sustainable asset-financing activities
- Qualitative information on how sustainability is being incorporated in in-scope financial institutions operating frameworks, including governance, strategy, and risk management.

The challenge banks face when analyzing climate risk

To comply with increasingly stringent regulatory disclosure requirements, banks need a way to assess climate-related risk comprehensively across all assets. This is especially challenging for non-listed private assets, real estate and infrastructure. For example, banks don't always have a method to assess how climate risk and extreme weather events might affect their portfolios. They may not have access to the necessary location data, or climate-risk data for private assets, real estate and infrastructure, which are most likely to be impacted by climate change. However, understanding how climate risks – such as chronic and acute extreme weather – affect these assets is crucial for EBA Pillar 3 compliance.

A recent study on ESG risk disclosures by European banks, as part of their EBA Pillar 3 reporting, found significant variation in the magnitude of physical risk reporting and the types of exposures sensitive to physical risk. This points to different methodologies and approaches being applied by banks to assess exposures to physical climate change events.[1]

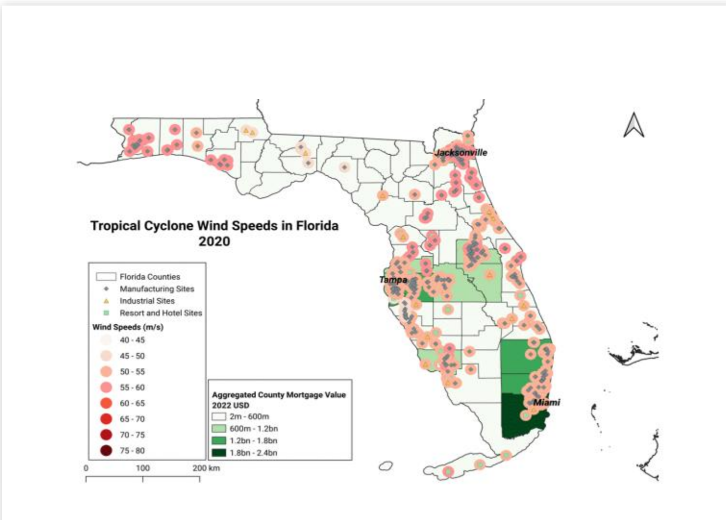
To be able to comply with EBA Pillar 3 and disclose climate risk effectively, banks need a complete understanding of how future extreme weather could impact their assets. Physical risks stem from hazards and costs related to extreme weather events or an increase in hazardous events, affecting building damage as well as operational and maintenance costs. Transition risks must also be considered to assess whether a building's future emissions align with decarbonization targets and how different scenarios might affect its ability to meet these goals.

Fortunately, banks can leverage solutions like MSCI's Geospatial Asset Intelligence to access extensive location data and physical risk attributes across all asset types which may be able to help with these new disclosure requirements.

1 A. Ludzuweit & A. Liang, Is the EU Banking sector ready for climate-related disclosures?, MSCI ESG Research, June 2024

How MSCI’s Geospatial Asset Intelligence solution can bring climate clarity
Understanding the localized effects of acute and chronic extreme weather events on lending activities is essential for accurate physical risk disclosures under EBA Pillar 3. Granular analysis, especially of acute events like flooding and wildfires, provides more accurate insights into these risks.

MSCI's Geospatial Asset Intelligence solution helps banks identify their exposure to physical climate risks across public, private, and real assets at a granular and location-specific level. Understanding the localized impacts of acute and chronic extreme weather events can enable banks to develop stronger strategies while aligning with Template 5 requirements published by EBA Pillar 3.



As of June 2024, the tool offers:

- A continuously expanding database of over 70,000 public and private companies, mapped to 1 million locations
- Full global coverage of any real estate asset
- Forward-looking analysis of 12 physical hazards across 11 climate scenarios (based on the Network for Greening the Financial System and the Intergovernmental Panel on Climate Change frameworks)
- Multiple time horizons: current, 2030, 2050 and 2100
- Quantitative assessment of both exposure and financial impact of all 12 perils
- Nature exposure and impact

Banks can run the risk assessment by climate scenario, hazard type, point in time, or granular location. Combined with physical risk return period reporting, MSCI’s Geospatial Asset Intelligence solution offers an extensive assessment of climate-risk impact to assets. These crucial insights aim to help banks enhance their investment strategies while aligning with regulatory requirements such as EBA Pillar 3.

To learn more about the impact of EBA Pillar 3 and how MSCI’s solutions can help contact us here.

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