ESG Now Podcast

“Are Banks Ready for Climate Risks?”

Transcript, 4 March, 2025

Mike Disabato (00:00):

What's up everyone, and welcome to the weekly edition of ESG Now, where we cover how the environment, our society and corporate governance effects and are affected by our economy. I'm your host Mike Deto, and this week we talk about the risks banks face to their loan portfolios due to climate change. Thanks as always for joining us. Stay tuned. Doomed banks are really just financial intermediaries. People make a deposit out of bank and banks lend them out to other people. Now, obviously, they've gotten a bit more complicated than that in their lending practices and they make riskier and thus more profitable bets with UN institutions money. But complexity aside, on a high level, that's basically what banks do. Now because of that, it's important. A bank engages in a continual study of their assets and liabilities because you don't want them to make too risky a bets.

(00:59):

And all of a sudden when you go to get your money from your bank, you find yourself talking to a man c clucking like George Bailey. Oh no, I don't have your money here. It's in Bill's house and Fred's house. Now, traditionally a bank would assess it's liquidity risk, it's interest rate risk, and it's credit risk, but it would look at historical data, it would project out their risk based on those historical qualities, and they would look at what the risk exposure is based on that projection. But this requires a standardization, which isn't great when you have to account for unexpected events such as, I don't know, the complications caused by climate change. What banks really need to do is also conduct climate scenario analysis. You remember that podcast we did recently on climate scenario analysis, right? Well, it wasn't just a theoretical exercise because believe it or not, there's a big fight right now about scenario analysis happening, and it's happening between the banking sector and its regulators across the world, not just how to model climate transition risks, but whether to do it at all on one side.

(02:04):

Regulators in many regions have said the disruption brought by the transition to a lower carbon economy could probably pose risks to banks, loan books, and we want banks to model those potential losses under different scenarios and tell us how that could happen. Do they face serious losses or is everything okay? On the other side? Banks are largely saying, well, no thanks. We have plenty of other stuff we have to worry about, plus if we do this, we probably have to increase our capital retainment requirements and it's going to cause us to hold a lot of cash and avoid investments which no one actually wants to have happen. Now, we saw a similar fight go down after the global financial crisis in 2008. There was this awakening to the systemic risks in the financial system and regulators rose capital requirements while banks pushed back on them to try and water them down. The outcome was the global capital requirement regulation called Basel three, and now we're starting to see this tug of war play out again, and we're not just seeing a bifurcation between banking authorities throughout the world, but we're seeing a furation. We're seeing a branching that's happening across the globe.

Anja Ludzuweit (03:11):

Traditionally, banks plan on a three to five year cycle for budgeting and stress testing.

Mike Disabato (03:17):

That was Anya Lite. She and our colleague, VI de Melo Silva, who is our banks and asset management researcher based in London. They recently published a report that looked at the preparedness of banks' loan portfolios for climate transition risks, which are those risks that arise from the global shift towards a lower carbon economy by looking at things like regulatory changes, technological shifts, investor preferences, and evolving consumer behavior. The unexpected macro events influenced by desire to slow the warming of the world. And she was just telling me about this divergence in regional banking regulations and climate transition risks.

Anja Ludzuweit (03:55):

But a major shift that is now coming with the regulation is really the time horizon. So for example, in Europe, we actually already have quite advanced approaches. So we already have banks that are being supervised by the European Central Bank and they had to integrate climate and environmental considerations into their risk management already for five years. Now, the EBA in their latest guidelines, they are now expecting banks to extend their risk horizon to at least 10 years because they actually recognize that these climate risks unfold over decades rather than years. And that really means that banks now are expected to change their approach to risk management, and they also need to think about how these potential transition risks are impacting their core risk categories, right? They have credit risk, market risk, liquidity risks. So how is that transition risk actually translating into their core categories?

Mike Disabato (04:56):

Now, that might just sound like my European colleague letting me know how much more aware their government is on the risks posed by climate change. But she's not completely wrong here. The EBA she mentioned, which is the European Banking Authority, it has shown that EU banks are adopting to the concerns around the risk of asset erosion caused by climate change risks, by charging clients with the highest carbon emissions 14 basis points, higher monthly interest rates than their lower emitting peers, and an additional 20 basis points for those that are lacking emission reduction plan. So that's a pretty strong message, but it's not one echoed across the globe

Anja Ludzuweit (05:33):

In other parts of the world. What we are seeing is that regulatory momentum could indeed slow. For example, in North America, we had the Canadian banking and insurance regulator implementing principles based rules on climate risk management. But actually what we just learned a few weeks ago is that they are delaying the reporting obligations on this risk management, especially on scope three emissions. And in apac, we are seeing really a trend toward adopting international sustainability reporting standards. And that could really set the scene for or could pave the way for stricter prudential ESG rules over the next few years.

Mike Disabato (06:18):

So in addition to Canada, there's the US and the US hasn't really signaled that it's going to put forth much in terms of climate focus regulation in the short term. So there's not much to talk about there. And also there's a big shift happening right now, and I would be loath not to mention it. There's a shift in where a lot of funding is being provided and it's going to the more opaque areas of the market, like private credit and commercial loans being investment funds and not banks. But for today, what's important to realize is that even in areas where regulators are signaling that paying attention to climate risks and transition risks, therein is an important factor for banks to think about. There is still a lack of disclosure by those banks on climate related risks that their portfolios face. Here's GUI telling me more about that.

Guilherme De Melo Silva (07:04):

I understand that just minority of banks have enough practice to manage transition risks in their portfolios right now. And according to our research, just a small percentage, just 20% have certain practices, although we are capturing publicly available information, not exactly what they implement, but in general, just a small percentage of banks are ready to consider these aspects in their daily activities and how they manage the portfolios.

Mike Disabato (07:33):

The complication there is what Anya and GH show in the research is this lack of stress testing for climate transition risks has put banks long-term assets at a higher probability of default. For some reasons that probability of default could have increased by as high as 50% over the long term. Here's Anya going through the findings.

Anja Ludzuweit (07:52):

So we looked at banks that are in our coverage. So it's really a broad mix of banks like diversified, regional banks and financial services, and we looked at that across three regions, Europe, Americas, and apac. And then what we did, we mapped these loan book activities across major sectors, so consumer discretionary materials, industrials, and then applied our scenario based climate adjusted credit model to these sector exposures. And so in essence, what we did here is we compared the probabilities of default that include transition risk factors and conventional baseline that basically excludes it. And for that analysis, we actually used a two degree disorderly scenario, and that is actually a very conservative scenario because it assumes that action on climate is going to be delayed, potentially uncoordinated. And we felt that this is increasingly realistic given the geopolitical situation that we are in. So what we actually found here was that in the near term, banks across regions may see only minor increases in the likelihood of defaults due to climate related transition risks. And that really seems logical given the assumption about delayed transition that's baked into the scenario. But what we did find was that over the longer horizon, so let's say 10 years or more even for this delayed scenario, the picture could shift dramatically, especially for banks in the apac.

Mike Disabato (09:34):

Now the reason for that is actually more to do with their loan portfolios rather than anything to do with regulations. APAC banks and our coverage have a high exposure to industrials, construction companies, machinery companies, transportation companies, the kind of companies ripe for either technological transition, which is focused on carbon reduction or to have costs imposed upon them based on their, what we call hard to abate or just emissions that are hard to get rid of. But the Y aside, if you look at the research that Angi put out in apac, if there is this disorderly transition where climate regulations transition risk comes online in a robust way, but kind of in a dispersed and non-standardized way, the probability of default for loans made by APAC banks could increase by 50% for loans on a 10 year maturity compared to their baseline. And now contrast that with banks in Europe and America, which have a lion's share of exposure to financial companies and real estate companies. Those companies that aren't facing the sort of risks that industrial companies are, their probability default for their 10 year loans increases by about 20%. Now, that's a lot for that probability to increase that much, but it's not as profound as apec. And really the thing to remember is that those profound probabilities of default really don't start to appear until around the 10 year mark. A five year loan, as Anya noted, has a much lower increase in its default probabilities compared to a 10 year loan.

Anja Ludzuweit (11:09):

So really when we bring this back to long-term investors, now for the long-term investor, that really means that you need to understand what is the underlying exposure that you have in your financial institution. So you really need to get a better handle on what are regional, what are sectorial exposures, and really understand that indirect impact that transition risks could have on the bank book.

Mike Disabato (11:37):

That is where regulation would come into play here. It isn't that regulation decides which banks are less exposed to which transition risks. As we saw, APAC is extremely exposed due just in part to the kind of companies that they hold. It is that regulation which asks banks to disclose on their risk for these climate factors would be easier for long-term investors to assess. Pensioners, for example, have a investment horizon that spans decades. If they're allocated to some banks that aren't incorporating climate risks in their stress test procedures, then there's a chance that those risks could impact the value of their pensions, which would be antithetical to the purpose of a pension. So to that end, I wanted to finish the episode by asking gee if he could give me his barometer on how he would tell if more banks were incorporating these aspects into the risk management procedures.

Guilherme De Melo Silva (12:24):

Definitely transparency will be a key element of banking, disclosing details about the portfolios and more information about how they expect to react to climate related aspects in terms of potential losses, opportunities, how they can create new opportunities by financing the transition of their clients. So all this we expect to be publicly available for the investors and regulators and to society in general to understand what banks are doing. And another element, of course, is the homework that banks have to do in terms of expanded their understanding of the portfolios, acquiring more data and capturing more information from their clients to understand how their clients are transitioning and adapting to climate and how they're factoring all these elements in their business.

Mike Disabato (13:14):

That last part is no easy task. It requires banks to engage with their clients to ensure they have a standardized approach to how they're reporting their climate risks. It again, puts more on a standardizing regulation that would ask companies to report their climate risk data in a way that can be incorporated into a large risk model at a regulated bank. But I'd venture to guess that most investors want more information, just want as much information as possible on material aspects to the things that they invest in. And the main takeaway here really is that around 80% of banks in our coverage aren't giving much information on how exposed or loans are to high polluting assets. And of course, that does create a black box in the market and that doesn't help anyone. And that's it for the week. I want to thank Anya and Gee for talking to me about the news with the sustainability twist, and I want to thank you so much for listening. If you like what you heard, don't forget to rate and review us. That always puts us higher on podcast lists and subscribe wherever you get your podcast. We're off next week, but I'll talk to you at the week after.

Speaker 4 (14:32):

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