KPMG

Banks and climate risk – Basel Committee reports

Global IFRS Institute

6 May 2021

Andrea Schriber
KPMG International

Basel Committee issues two new reports on climate-related financial risks

Highlights

- Banks are exposed to both physical and transition risks
- Measuring climate risk – Establishing a methodology
- What's next?

How are banks affected by climate change risks – and how are they currently measuring them?

These questions are the focus of two analytical reports from the Basel Committee on Banking Supervision:

- **Climate-related risk drivers and their transmission channels**; and
- **Climate-related financial risks – measurement methodologies**.

The reports leverage extensive reviews of existing literature and are intended to be read in tandem.

Banks are exposed to physical and transition risks

The first report explores how climate-related financial risks arise and affect both banks and the banking system.

Key points to note

- Banks and the banking system are exposed to climate change through macroeconomic and microeconomic transmission channels that arise from two distinct types of climate risk drivers: physical and transition climate risk drivers.
- The traditional risk categories used by financial institutions and reflected in the Basel Framework can be used to capture climate-related financial risks. These categories are credit risk, market risk, liquidity risk, operational risk and reputational risk.
- The economic and financial market impacts of physical and transition risks can vary according to geography, sector and economic and financial system development. For example, climate-related exposures vary according to the geographic location of a bank and its exposures based on different weather patterns, natural environments, political systems and consumer sentiment.

Measuring climate risk – Establishing a methodology

The second report provides an overview of conceptual issues related to climate-related financial risk measurement and describes banks' and supervisors' current and emerging practices.

Key points to note

- Climate-related financial risks have unique features, which means that sufficiently granular data and forward-looking measurement methodologies have to be developed and conventional risk management tools may need to be adapted to incorporate those risks.
- Currently credit risk measurement has attracted the most effort, with a lesser focus on other risk categories.
- The work done by banks is continuing to gather pace. Banks and supervisors are in the initial stages of translating climate risks into robust, quantifiable financial risks. Initial scenario analyses and stress tests have focused on selected portfolios or exposures for transition risks, and selected hazards for physical risks.
- A range of methodologies is currently in use or is being developed; however, challenges remain in the estimation process, including data gaps and uncertainty associated with the long-term nature and unpredictability of climate change. As banks address these challenges, their ability to estimate and effectively mitigate climate-related financial risks will improve.

What's next

The reports provide a conceptual foundation for the Committee's next phase of work – identifying potential gaps in the Basel Framework and considering measures to address them.

Publication name: *Banks and climate risk – Basel Committee reports*

Publication date: March 2021