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A practitioner's view: Growth of taxonomies and climate risk management

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Introduction

Banks play a critical role in achieving the goal of carbon neutrality. They have the wherewithal to redirect capital flows towards environment friendly activities. The question really is what qualify as "sustainable economic activities?" Taxonomies provide clear indicators in this direction. The primary focus of taxonomies is to have a standard, acceptable explanation of what qualifies as "green" or "brown" investment or financing.

BIS, in its paper "A taxonomy of sustainable finance taxonomies" describes a taxonomy as "a set of criteria which can form the basis for an evaluation of whether and to what extent a financial asset can support given sustainability goals." Regulators, global organizations, and academic institutes are in the process of creating, and refining taxonomies, with regulators being the front runners.

The purpose of this article is to briefly explore how taxonomies can influence and aid climate change risk management. It looks at the pointers that taxonomies provide, which can support better managing climate risk.

Climate risk taxonomies

The first set of taxonomies is led by regulators who identify sustainable financing activities. These could be regional level taxonomies like the ones from the European Union (EU) or the ASEAN Taxonomy for Sustainable Finance[1], or country centric.

The importance of awareness

The other class is focused on specifics, like the climate risk taxonomy, and offer an alternative but complement the above taxonomies. Examples of each of the two classes of taxonomy are below:

1. The EU Taxonomy is the front runner in sustainable finance taxonomies. It is a science-based classification system that lists environmentally sustainable economic activities as "green" with the expectation that the financial industry will focus on these activities to boost sustainable investment as a means towards achieving a climate neutral Europe by 2050. As of 1st January2022, the taxonomy covers two themes of climate mitigation and adaptation.
2. The Climate Risk Taxonomy's focus is on identifying and defining risk categories associated with climate factors. Climate risks constitute a broad set of risks. Granulating them into a standard taxonomy helps users better understand and assess the connected risks.

Pointers of risk management from taxonomies

Is there a direct link between the EU Taxonomy, for example, and risk management? Probably not. Sustainability taxonomies stipulate the target and not how the risks can be managed. Climate risk taxonomies go a step further as they identify and assess the potential scope of impact. However, both types provide directional indicators for the various phases of climate risk management.

[1] https://asean.org/book/asean-taxonomy-for-sustainable-finance/

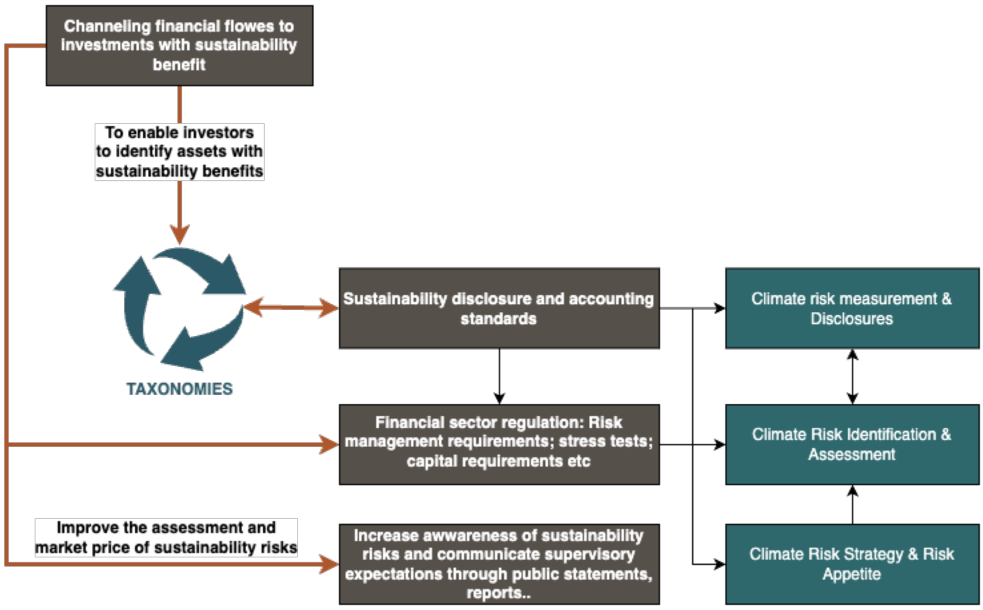

Figure 1 – Pointers to Climate-related Risk Management
Source – Adapted from BIS Paper No 118- A taxonomy of sustainable finance taxonomies – October 2021 with author extensions

Risk appetite and strategy

Banks, globally, have made commitments towards transition to low carbon economy, both for their own operations and for the businesses they finance. It gets reflected in their climate strategy. Risk appetite statement, flowing from the climate strategy, is required to spell out the industries, activities, geographies, product, and services of focus. Taxonomies provide the guidance of what activities qualify as "green" from which banks can choose their preferred portfolio to achieve the climate targets set by them.

Risk identification and assessment

Climate risk taxonomies aid in identifying climate risks inherent in potential projects before they cause reduction in asset utilization, create stranded assets, reduced income and margins, or other negative financial impacts. These could result in credit risk and influence a lender's decision in extending finance to entrepreneurs. The transition risks due to adaptation or mitigation are spelt out in taxonomies, which aid banks identify risks and decide whether to filter out or accept the risks. They also provide insights that help an informed assessment of risks by:

1. Indicating activities or industries that are less likely to be impacted by policy changes and therefore lower on transition risk.
2. Indicating the impact on counterparties that need to be factored into assessments

Risk measurement and disclosures

At a bank level, measurement of "greenness" of its portfolio is required internally as well as expected externally for disclosures. Taxonomies, through the KPIs, help gauge how much of the business is green, thereby assessing individual bank alignment to the net zero goals it has committed to. Comparable key performance indicators like GAR (Green Asset Ratio) and BTAR (Banking Book Taxonomy Alignment Ratio - will apply from June 2024), as conceptualized by the European Banking Authority, help measure the sustainable financing as a percentage of their total portfolio.

At the individual counterparty level, taxonomy alignment will be a key factor in climate blended rating as well as in project evaluation.

Conclusion

Taxonomies are here to stay, grow stronger and become a pervasive mechanism that transparently explores, compares, and declares investor and lenders' environmental footprint. It is an evolving discipline, where taxonomy metrics are developing. An example is the identification of "Standardized Transition-risk Exposure Coefficients (TECs) reflecting the transition potential, as well as transition-risk exposure, of each sector."

Risk managers will do well to keep abreast of this space not only for mandatory disclosures but also to leverage the content for embedding nuances of climate risk management into their ERM framework. This not only enables deployment of funds towards creating and maintaining a sustainable ecosystem, but also for better managing climate-related financial risks.

For more details, message me to discuss how Oracle can support your start to the sustainability reporting journey.

You can also visit our website to learn more about the Oracle Climate Change Analytics Cloud Service solution.

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