French banks: supervisory pilot test reveals moderate exposure to climate risks

Scope Ratings

French banks display moderate exposure to climate risks, according to a pilot exercise performed by the ACPR, the French financial supervisory authority, between July 2020 and April 2021. This is the first assessment of financial risks stemming from climate change performed by the French authorities.

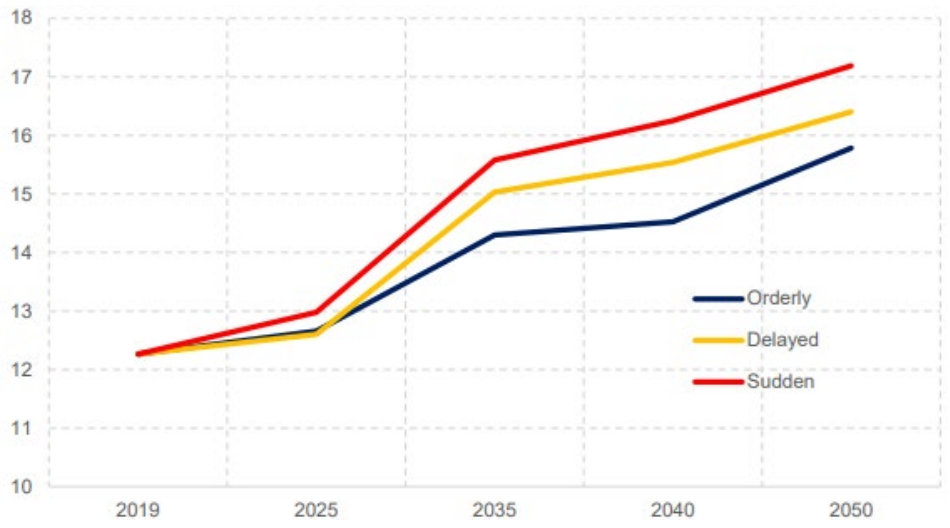
The main goal of the exercise is to raise awareness of climate risk. Participation in the pilot exercise was voluntary, so the results do not translate into any regulatory actions or requirements for corrective measures. But we believe the increased momentum around climate stress tests for financial institutions matters more than the outcome of the exercise.

Measurement of carbon emissions and climate stress tests are the two main areas of focus for banks when it comes to describing their exposure to and management of environment-related risks. The French pilot exercise focused on banks' exposure to the two analytical subsets of climate risk: transition and physical risk.

Transition risk

The overall 'moderate' impact of climate risk on French banks' credit quality can be explained by their geographic and business exposure. The most sensitive exposures represent a relatively small part of total lending, accounting for only 9.7% of corporate portfolios. The test also identifies 'winning' sectors i.e. those that would experience a decrease in probabilities of default such as the construction sector, for which transition is an opportunity.

Figure 1: Cost of risk trends for six largest French banks



Source: ACPR, Main results of the climate pilot exercise for 2020

The net impact of transition risk on credit costs depends on the transition patterns (orderly, delayed, sudden), but it remains below 20bp which is low in our view. This is explained by the size of the overall exposure and the assumption of a generally resilient operating environment. The ACPR used various scenarios, based on the premise that carbon neutrality will be achieved by 2050.

Analyst

Nicolas Hardy - Paris
n.hardy@scoperatings.com

Team leader

Dierk Brandenburg
d.brandenburg@scoperatings.com

Media

Keith Mullin
k.mullin@scopegroup.com

Related Research

European banks: mind the GAR (Green Asset Ratio)
March 2021

Assessing ESG as a component of bank credit risk. Part 2: social factors
March 2021

Assessing ESG as a component of bank credit risk. Part 1: environmental factors
February 2021

Scope Ratings

Lennéstraße 5
D-10785 Berlin

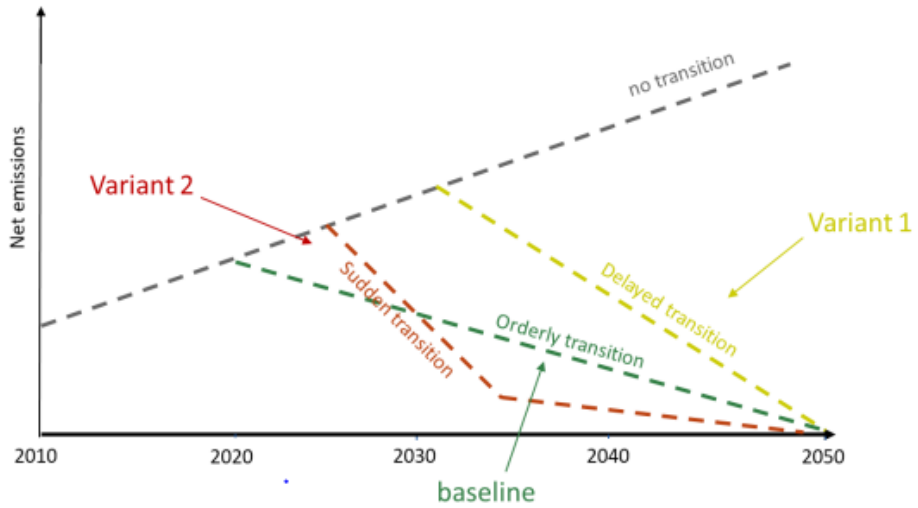
Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: RESP SCOP

The fact that most scenarios assume by design that the objective of carbon neutrality by 2050 will be reached is openly stressed as a limitation. The range of scenarios proposed by the Network for Greening the Financial System (NGFS), made up of central banks and supervisors across the globe. is much broader. They will likely be integrated into following rounds, according to progress made against the goal of carbon neutrality.

Figure 2: selected scenarios under the ACPR pilot exercise



No transition; orderly transition (baseline, straight line to 2050); sudden transition (abrupt then normalising); delayed transition (late and abrupt)
Source: ACPR

Physical risk

Physical risk assessment needs improvement

Better assessment of physical risks for banks is earmarked as an area that needs improvement. The ACPR report highlights the operational challenge for banks to obtain a precise consolidated view of the geographical location of their exposures.

The pilot exercise looks at banks and insurance companies separately. But it also highlights the close interactions between the insurance and banking sectors as they adapt to climate risk. For banks, an increasing protection gap or rising insurance costs will have direct effects on their ability and willingness to underwrite risks. This is more acutely perceived for two types of exposures: the financing of real estate or its usage as collateral; and companies operating in the sectors most vulnerable to climate and environmental risks and therefore more frequent users of credit mitigants.

The ACPR pilot acknowledges the major uncertainty related to both the speed and the impact of climate change. A major benefit of climate stress tests is creating a dedicated timeframe for measuring climate risk. In the meantime, the need to model risks over an extended time horizon creates additional hurdles in comparison to traditional stress test exercises, which are usually limited to shorter time horizons.

Given this extended timeframe and unlike traditional stress tests, the climate stress test allows corrective measures to be integrated in the form of management actions, and the modelling of dynamic balance sheets, like corporate portfolio re-allocation.

Identifying most sensitive sectors and reviewing adaptation strategies

From a credit rating perspective, identifying the most sensitive corporate sectors and reviewing strategies to adapt to climate risk are direct inputs into bank credit rating analysis. A list of seven most sensitive sectors is provided: crop and animal production; mining and quarrying; manufacture of coke and refined petroleum products; manufacture of chemicals and chemical products; manufacture of other non-metallic mineral products;

manufacture of basic metals; sewerage, waste collection, treatment and disposal activities.

The pilot highlights the challenge of setting the most relevant criteria, which at this stage may lack sophistication. Looking for the sectors that are the larger contributors to greenhouse gas emissions (volumes) produces different results to focusing on the potentially bigger financial risk associated with the introduction of a carbon tax.

The pilot also highlights the degree of divergence in the results in terms of cost of risk for individual banks. This is a function of initial exposure to sensitive sectors but also the variety of strategic options applied by individual banks over the 2020-2050 period. They range from the strict early application of an exclusion policy to a more inclusive credit policy to accompany clients as they transition. In our view, there is no one size fits all strategy to optimise for credit risk arising from climate risks.

More accommodating credit policies could result, as pointed out in the report, in more lasting exposure to transition or physical risks than expected. More radical sector exit strategies to limit exposure to stranded assets could result in a lower climate risk-related cost of risk but they could also create more severe near-term franchise issues resulting in lower risk diversification to cope with economic downturns, lower revenue generation and lower loss-absorption capacity. In contrast, the maintenance of a more diversified credit portfolio, increasingly pricing in a premium for higher climate risk, could drive a more gradual reduction while also maintaining greater capacity to absorb credit losses through the cycle.

Drive to climate exposure checks accelerating

The drive to conduct climate exposure checks on the banking sector is accelerating. The ACPR expects to repeat its exercise regularly. Next month, the Bank of England will launch its test of the UK financial system's resilience to the financial risks from climate change as part of the 2021 Biennial Exploratory Scenario (the Climate BES). The European Central Bank is also due to perform a climate stress test in 2022.

We see value in linking banks' expected financial performance to environmental risk. This is the aim of the NGFS. The French pilot exercise is a contribution to this effort to highlight the transmission channels between the emerging physical and transition risks of climate change and the traditional financial risk taxonomy developed under the Basel capital adequacy framework for credit, market, and operational risks.

Coherent and large-scale regulatory initiatives are paving the way for science-based integration of environmental ESG risks and opportunities into credit analysis and credit ratings. The output will help closing the current disclosure gap.

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
23 Boulevard des Capucines
F-75002 Paris

Phone +33 1 8288 5557

Oslo
Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

Madrid
Edificio Torre Europa
Paseo de la Castellana 95
E-28046 Madrid

Phone +34 914 186 973

Milan
Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Scope Ratings UK Limited

111 Buckingham Palace Road
London SW1W 0SR

Phone +44 (0)20 7340 6347

info@scoperatings.com
www.scoperatings.com

Disclaimer