

Climate policy risk

How does this become a credit risk for banks?

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This briefing outlines our thinking on how emerging policy to address climate change could impact banks by impacting the credit quality of lending and trading portfolios, particularly to sectors and geographies that are more vulnerable to climate policy risk.

Climate change is happening and governments are starting to address it

Scientists¹ agree that climate change is happening and is extremely likely to have been caused by human activity, primarily from the burning of fossil fuels. Scientists also agree that global warming above 2°C (relative to pre-industrial levels) could have potentially catastrophic physical impacts on the planet, with equally serious knock-on economic and social effects.

The Paris Agreement, made up of Nationally Determined Contributions (NDCs) – commitments to reduce greenhouse gas emissions – has been ratified, and entered into force on 4 November 2016. These imply a step change in efforts to

reduce emissions, doubling the annual rate of decarbonisation from 1.3% to 3% p.a. This low carbon transition will impact businesses in the energy, heavy manufacturing, mining, transportation and real estate sectors. The agreement also includes a ratcheting process starting in 2018 to further increase decarbonisation rates towards the required 6.5% p.a. to limit global warming to well below 2°C. This rate of decarbonisation is significant: it is about double that achieved by the UK's "dash for gas" in the 1990s and the US's recent shale gas revolution.

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¹ Intergovernmental Panel on Climate Change (IPCC) – Fifth Assessment Report (2014)



Emerging climate policy can impact your clients' financial performance

Many countries have started implementing climate-related policies. For example, China is expected to bring a national carbon pricing programme in place by 2020 and its national policies have already reduced its coal demand by 3.7% in 2015², creating a knock-on effect on world coal prices. Meanwhile, its solar capacity has increased by 74% and wind by 34%. The US Clean Power Plan, assisted by the shale gas revolution and global drop in coal prices, has contributed to a notable number of bankruptcy filings amongst US coal companies – 6 in the last 18 months alone.

Barclays Equity Research recently published a report³ on German utilities which analysed how different companies would be impacted by the transition to a low carbon economy. Although focused on equity valuation, the analysis looks at financial impacts which are fundamental to credit risk analysis. The report showed how a carbon tax would affect earnings, and considered carbon price scenarios consistent with the agreed NDCs as well as with the tougher 1.5°C ambition; it also suggested that climate policy would have to be tightened post-2020 in order to meet stated German, EU, and global ambition

for cutting emissions. The report concluded that given the German electric utility company RWE's greater exposure to lignite (a lower quality type of coal that releases more greenhouse gas (GHG) emissions when burnt) and European holding company E.ON's greater exposure to a more efficient fleet of gas-fired power, RWE's portfolio faces a downside of EUR1.8bn compared to E.ON's upside of EUR500m.⁴

A recent study by the University of Cambridge and the Investors Leaders Group⁵ piloted a bottom-up model analysing the impact of climate policy on individual company profitability in the oil refining, gas production, and electric utilities sectors in the UK, Spain, US, Germany and Canada. The results suggest that the impact of climate policy on profitability can vary widely between sectors and even within sectors – Canadian utilities could face 3% drops in profit compared to Spanish utilities which could have increases of 84%. Amongst Spanish utilities themselves, changes in profitability margins ranged from -74% to +300%.

² China National Bureau of Statistics

³ Scoping the Tragedy of the Horizons (Sep 2016)

⁴ Since publication, in September 2016, E.ON spun off their conventional power business to a company called Uniper.

⁵ Feeling the heat: An investors' guide to measuring business risk from carbon and energy regulation (2016)

The most tangible financial impacts for banks are likely to be impaired asset values and loan books, for example, if the valuation of fossil fuel companies' reserves cannot be realised.

Such impacts could have knock-on effects on a bank's credit profile ...

Ratings agencies are starting to recognise how climate policy risk for companies can quickly transfer as credit risk to their bankers. Standard and Poor's (S&P) released a paper⁶ outlining the multi-layered long term consequences of climate change for banks which include increases in bad loans, falling asset values, as well as additional regulatory costs and increased reputational risk. In this paper, S&P argues that the financial sector has a key role to play in the transition to a low carbon

economy, which if not actively filled, may compel regulators to act. The most tangible financial impacts for banks are likely to be impaired asset values and loan books, for example, if the valuation of fossil fuel companies' reserves cannot be realised. Whilst this impact may be low initially, S&P expects it to grow. The ratings agency also sets out indicators it will increasingly use to identify financial services companies that are likely to be hardest hit by climate change.

... and cumulatively, on the financial system

There is a wider risk to be considered. Banks are key actors in the financial system, facilitating and providing significant amounts of capital, alongside other actors such as institutional investors, asset owners and insurers. If collectively unidentified and un-managed, credit risk driven by climate policy could concentrate in banks' lending portfolios (and investors' portfolios) and create a systemic risk to financial stability.

The G20's Financial Stability Board recognises this risk and its Chair, Bank of England Governor Mark Carney, has created the Task Force on Climate-related Financial Disclosures (TCFD). The Taskforce aims to improve reporting on the financial impacts of climate risk (including from climate policy) so that lending, investing and underwriting decisions can be better informed and correctly priced so as to avoid abrupt market corrections. The TCFD report is expected to be released for public consultation by the end of 2016, with adoption expected in early 2017.

The European Systemic Risk Board has acknowledged the risks presented by a low carbon transition⁷ and suggests that policy makers should be incorporating climate-related risks into regular stress tests, in collaboration with the European Central Bank.

Some regulation has already started to emerge – France's Energy Transition Law (Article 173) requires all listed companies to report on the financial risks arising from climate change. A government report is expected to be submitted to Parliament by the end of 2016 which outlines the implementation of regular stress tests reflecting risks associated with climate change.

⁶ Climate change-related legal and regulatory threats should spur financial service providers to action (May 2016)

⁷ Too late, too sudden: Transition to a low carbon economy and systemic risk (Report No. 6, February 2016)

We expect that over time, regulatory disclosure and stress testing requirements will become more common.

Our view

Given the swift ratification of the Paris Agreement, we think that climate policy will emerge sooner than expected; strategic risk appetite allocation and transactional decisions made by banks today should anticipate such emerging climate policy risks and correctly integrate such impacts to credit risk management. At the transaction or client level, banks should start incorporating the financial impacts of climate change into standard credit risk analysis, and request better disclosure of these risks from their clients and counterparties. At the portfolio level, by applying stress tests, banks can start to consider how climate change and its possible impacts on credit quality may impact capital adequacy requirements.

All of these will also need to be reviewed in anticipation of the IFRS9 changes to impairments accounting rules where a more forward-looking and continuous assessment of credit quality will be needed, and in some cases, over the lifetime of a particular exposure.

The TCFD's work will also drive expectations that climate risk disclosures will increasingly be focused on financial impacts, which gives rise to governance implications for the risk and audit committees of companies. We expect that over time, regulatory disclosure and stress testing requirements will become more common.

Climate change is no longer just a reputational issue for banks, it can have real impacts on the credit quality of borrowers which investors, auditors and regulators will want to understand. We are seeing a number of forward-thinking banks place climate change in their risk management frameworks and start to assess the implications of climate change on their lending and trading books.



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