



The impact of climate-related and environmental risks (CER)
on the financial sector: Risk identification and assessment

Climate-related and environmental risks (CER)

Identification and initial assessment (1/2)

Banks must develop a process which identifies and assesses the CER which may impact their overall risk profile. The foundation of this process is a risk taxonomy, which provides structure to the approach, and may contain the following components.

CER-drivers

CER-drivers are external events or conditions that can have both a positive (opportunity) or negative (risk) impact on a bank's risk profile in the short, medium or long term.
CER-drivers can be subdivided into **transition** and **physical** risk drivers.

Impact of CER-drivers

CER-drivers can have an indirect impact (through the bank's counterparties) or a direct impact on the bank's risk profile.
Indirect impact may affect the **revenue, costs, capital expenditures, or assets** of the bank's counterparties.

CER-sensitivities

CER-sensitivities refer to characteristics of the bank's counterparties to measure the magnitude of the potential impact on the bank's risk profile.
CER-sensitivities can be aggregated to a **CER score**.

Risk factors

Existing **risk factors** used to measure, manage, and monitor the bank's risk profile that may be affected both positively and negatively in the short, medium, or long term by CER-drivers in combination with their impact and sensitivities.

The assessment of the relevant CER-drivers is performed separately for physical and transition risk as they impact banks in different ways.

Physical risk¹

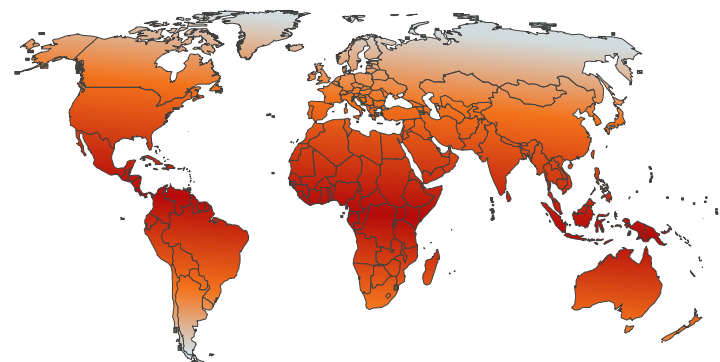
Physical risk refers to the financial impact of a changing climate, including more frequent extreme weather events and gradual changes in climate, as well as environmental degradation, such as air, water and land pollution, water stress, biodiversity loss and deforestation. Physical risk is therefore categorised as

- **“acute”** when it arises from extreme events, such as droughts, floods and storms, and
- **“chronic”** when it arises from progressive shifts, such as increasing temperatures, sea-level rises, water stress, biodiversity loss, land use change, habitat destruction and resource scarcity.

Transition risk¹

Transition risk refers to an institution's financial loss that can result, directly or indirectly, from the process of adjustment towards a lower-carbon and more environmentally sustainable economy.

This could be triggered, for example, by a relatively abrupt adoption of climate and environmental policies, technological progress or changes in market sentiment and preferences.



(1) cf. ECB - Guide on climate-related and environmental risks – supervisory expectations relating to risk management and disclosure, 11/2020.

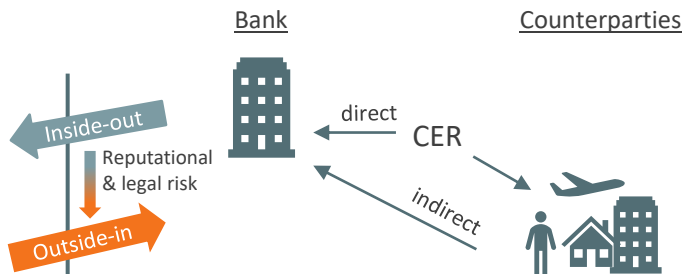
Climate-related and environmental risks (CER)

Identification and initial assessment (2/2)

The relevant CER-drivers may impact the bank in various ways. The differences in impact arise from the bank's business activities and portfolios, and depends on the interaction between the bank, its counterparties, and the environment.

Direction of impact

Environment

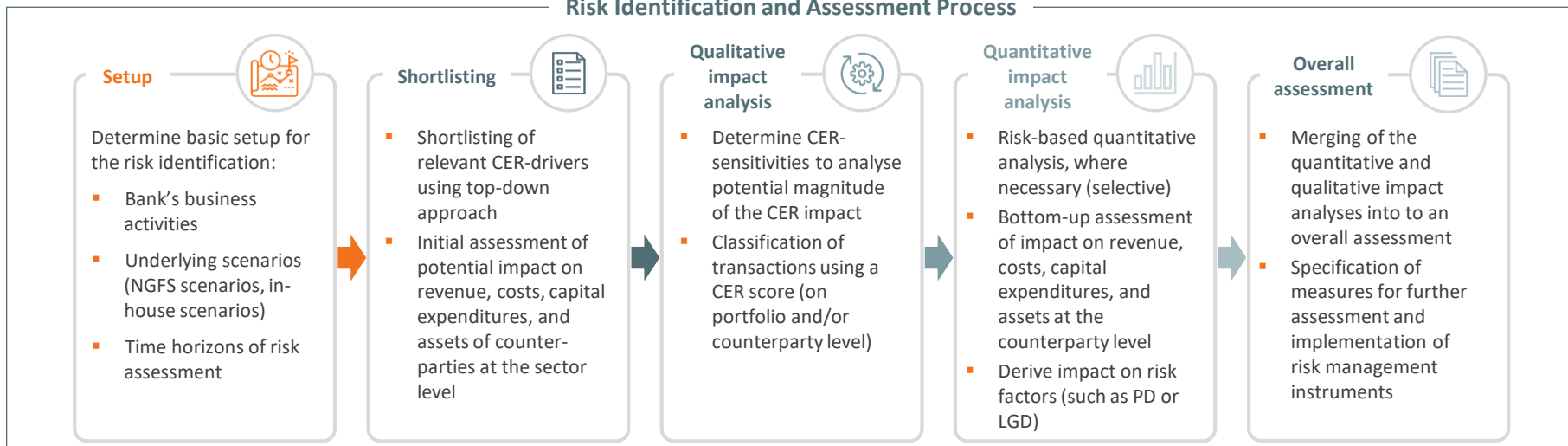


Direct vs. indirect impact

- Identification of **relevant CER-drivers and their impact on the bank's risk profile** along the bank's business activities and portfolios.
- **Direction of impact:** CERs act externally on the bank and its risk factors (outside-in) or CERs are caused by the bank (inside-out). Inside-out risks can indirectly re-impact the bank via legal and reputational risks.
- **Direct vs. indirect impact:** CER-drivers can have an indirect impact (e.g. through its counterparties) or a direct impact on the bank's risk profile.
- **External information** can be used for the identification of relevant CER-drivers and their impact on the bank or the bank's counterparties.

The risk identification and assessment process can be adapted to the intended level of sophistication, which is based on the business strategy as well as on the nature, scale, complexity, and risks of the bank's business activities.

Risk Identification and Assessment Process





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