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Climate risk management (CRM) and how it relates to achieving alignment with climate outcomes (ACO)

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ABSTRACT
Instead of incidentally contributing to Alignment with Climate Outcomes (ACO) through Climate Risk Management (CRM) initiatives like the Task Force on Climate-related Financial Disclosures (TCFD), we need specific ways of dealing with and contributing to the challenge of alignment. These need to be articulated, developed, and scaled across the financial system rapidly. Without rebalancing the distribution of effort and spending more time explicitly on ACO, we cannot ever hope to align finance and the financial system with climate change objectives. One of the most significant things policymakers can do to spur rapid ACO is to make ACO targets and transition plans mandatory for all financial institutions as soon as possible.

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Over the last decade the idea that climate-related risks, whether physical or transition, can strand assets in different sectors of the global economy has become much more widely accepted (Caldecott 2018). The threat of climate-related risks stranding assets has spurred work by financial supervisors and central banks, who have announced new supervisory expectations and climate stress tests to help improve the solvency of individual financial institutions, as well as the resilience of the financial system as a whole (NGFS 2019). The G20 Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) has created a framework to help companies and financial institutions consistently measure, manage, and report their climate-related risk exposures (TCFD 2019). There have also been a plethora of new initiatives, products, and services intended to help financial institutions measure and manage climate-related risks.

But climate risk management (CRM) is often erroneously conflated with seeking or achieving alignment with climate outcomes (ACO). While there is some overlap between CRM and ACO they have different objectives and often different results.

CRM can make little or no contribution to ACO. For example, reducing a company's exposure to projected increases in Country A carbon prices could entail moving emitting

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production to Country B which has lower environmental standards, potentially increasing net carbon pollution overall. Or a company could hedge its exposure to projected increases in carbon prices through derivatives contracts such as swaps, which would not alter the underlying economic activities of the firm and thus have little or no impact on emissions. Or a retail investor could disinvest shares from a fossil fuel company listed on the FTSE 100, thereby reducing their exposure to climate-related transition risk, but this will make very little or no difference to whether the fossil fuel company becomes more likely to achieve ACO (Ansar et al. 2013). Depending on who buys the disinvested shares, it could in fact, make ACO less likely (Ansar et al. 2013).

This is not to say that CRM cannot, intentionally or unintentionally, result in better climate outcomes. A way to reduce Company A's exposure to projected increases in carbon prices could be reducing the company's carbon emissions, thereby helping ACO. A universal owner, such as a large pension or sovereign wealth fund, by advocating for timely and effective climate action by governments could potentially contribute to lower climate-related transition risks across their holdings if governments heed their advice. CRM and ACO can work together in specific financial products, for example, a bank providing a sustainability-linked loan. Company A secures a lower cost of capital from the bank if it achieves ambitious, predetermined carbon reduction targets. A lower cost of capital is possible because Company A has calculably lower credit risk due to less energy use resulting in lower energy bills and lower potential future carbon price liabilities. The lender can share some of that reduction in credit risk with the borrower, creating a win-win where the borrower secures a lower cost of capital and the bank makes more money.

These synergies between ACO and CRM are clearly important, and it makes sense to maximise them at every opportunity. But that is different from saying there is always a positive relationship between them both, or that CRM automatically and inevitably leads to ACO. It does not.

There is a risk associated with the accidental (or sometimes intentional) conflation of CRM with ACO. Firms and financial institutions signing up to the TCFD, for example, may think that by doing so they are making a difference to the climate, when this is not necessarily the case. Policymakers and civil society groups may have unintentionally made this mistake easier to make, by hyping-up one CRM framework, the TCFD, in a way that is disproportionate to its potential climate impact.

The TCFD was announced on the sidelines of COP21 in Paris in December 2020. Progress has been made over the last five years but it also highlights some of the challenges of relying on disclosure as a theory of change. Even if every economic and financial actor signed up to the TCFD and implemented it perfectly, we would still not have global ACO. And, of course, the idea that we will secure comprehensive or effective TCFD implementation globally anytime soon is naïve. It will take many more years to achieve anything like global coverage for some of the most basic climate-related information disclosures. In an area where time is of the essence – we must achieve net zero emissions by mid-century to deliver Paris, and physical climate-related risks are already having a material impact – this is deeply unsatisfactory.

Instead of incidentally contributing to ACO through CRM initiatives like the TCFD, we need specific ways of dealing with and contributing to the challenge of alignment. These need to be articulated, developed, and scaled across the financial system rapidly.

Without rebalancing the distribution of effort and spending more time explicitly on ACO, we cannot ever hope to align finance and the financial system with climate change objectives.

What should we do? First, we should lock-in and continue to build on the critically important CRM work, including the TCFD. That could include making TCFD mandatory, but could also include a range of potentially very beneficial things for CRM, including updating risk-based capital adequacy frameworks so they take account of climate-related risks; spurring the next generation of data and analysis capabilities required to properly measure and manage such risks; and changing supervisory expectations globally so all supervised firms, from asset owners to insurers, need to action climate-related risks at the board and senior management-levels or risk supervisory action.

Second and in parallel, we need to urgently open up new frontiers for ACO, of which there are many. Together they should demonstrate the collective intent for massive material change in future financial flows, as well as the widespread adoption of financial practices that actively support the transition to net-zero emissions at the pace and scale required.

This could include the introduction of mandatory ACO targets and transition plans for financial institutions, setting out how portfolios and loan books could become increasingly compatible with different global warming thresholds at given levels of confidence (Caldecott 2020b), as well as how financial institutions could scale the provision of transition finance to support clients realise ACO (Caldecott 2020a).

Mandatory ACO targets and transition plans would create demand for new packages of financial products and services to help counterparties transition, as well as create demand for new ways of accurately measuring and tracking alignment.

This would spur interest in and concern for ACO in a dramatic way, without prescribing the exact transition pathway for financial institutions to achieve ACO. One of the most important things policymakers can do to spur rapid ACO is to make ACO targets and transition plans mandatory for all financial institutions as soon as possible.

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