Briefing

Results of Bank of England's Climate Biennial Exploratory Scenario

May 2022

Summary

On 24 May 2022, the Bank of England published the results of its first ever Climate Biennial Exploratory Scenario (CBES). These clearly show that the UK's financial system is exposed to high levels of climate-related financial risk, both from the direct impacts of climate change and the changes needed to achieve a net zero carbon economy.

Without early mitigation, these risks will layer on further economic disruption and costs to financial institutions, businesses and households already concerned about economic headwinds.

The Bank of England is clear that, whilst the tools at its disposal will help to ensure resilience against the consequences of climate change, "the responsibility for addressing the causes of climate change ultimately lies with governments, businesses and households".

Therefore, parliamentarians have an essential role to play in reducing the level of climate-related risk the financial system is exposed to. Such interventions include:

- stronger regulation of the private sector to stop environmentally damaging investments;
- greater support for financing green investments;
- improving transparency and preventing greenwashing in the financial sector through the green taxonomy and mandatory transition plans.

Headline findings

With the participation of 19 leading UK banks and insurers, the CBES set out to understand the resilience of financial institutions and the broader financial system to climate-related risk.

There are three consistent themes in the findings: 1) early climate change mitigation is essential to reduce financial risk; 2) current modelling and climate risk assessment is insufficient; and, 3) some economic sectors will be unviable in the future economy.

Early climate mitigation is essential to reduce financial risk

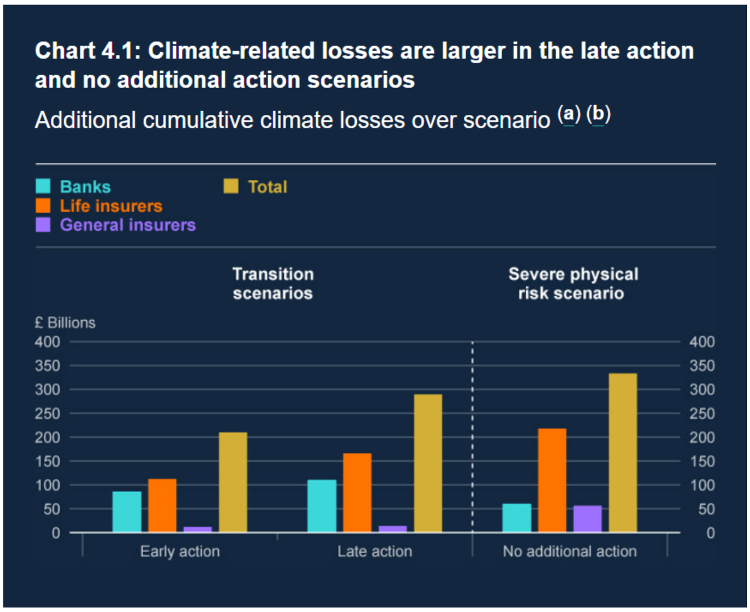
The CBES explored climate-related financial risk over the next three decades in three scenarios: early action, late action and no additional action.

The results show that an early and orderly transition to a net zero carbon economy would not only reduce the level of systemic financial risk, but it would also reduce the financial impacts of climate change, experienced by banks and insurers, businesses, and households.

Without an effective response to climate change, the CBES suggests that **climate risks could cause a "persistent and material drag" on the profitability of banks and insurers of around 10 to 15 per cent annually overall.**

Projected losses for banks and insurers increase substantially the later action is taken. In the no additional action scenario**, banks and insurers face losses of £334 billion by 2050** (see chart below).

Whilst some transition costs appear absorbable, losses of this scale could leave institutions vulnerable to further shocks, threatening the stability of the financial system.



(Source: Bank of England's results of the 2021 Climate Biennial Exploratory Scenario (CBES))

There is a risk that financial institutions may pass these costs on to both businesses and households.

In the no additional action scenario, participants indicated that around **seven per cent of UK households (two million homes) could be forced to go without insurance**, because their homes will become uninsurable, for example due to flooding or because they cannot afford higher premiums.

Those without insurance may then struggle to access finance from banks, such as mortgages, as their property price falls

Insufficient climate modelling and climate risk assessment

The CBES concluded that, whilst financial institutions are making progress on their climate risk management, they must prioritise improvement of risk assessment capabilities.

Few banks have in-house climate risk capabilities, relying instead on unproven third parties. More broadly, there is a lack of quality or standardised data to support the measurement, assessment and modelling of climate-related risks.

Due to insufficient data, the CBES suggested that **banks and insurers are not able to reflect climate risk in their business decisions accurately**. This masks their real financial resilience.

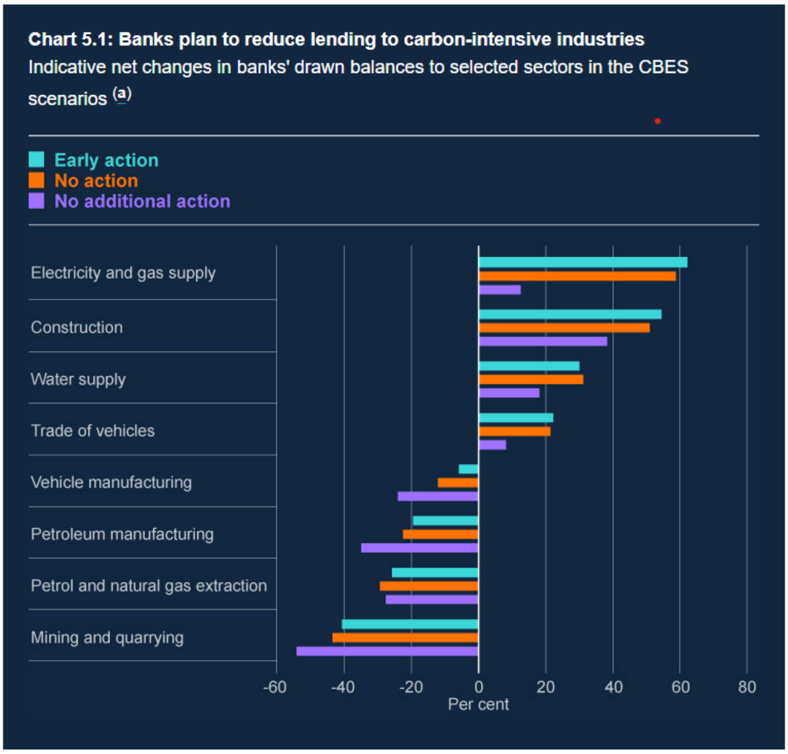
Certain economic sectors will become unviable

The CBES is yet more evidence that, during the transition, certain economic sectors will be materially impacted. Projected highest losses are in mining, petrol and natural gas extraction, transport, and the wholesale and retail trade. Cumulatively, these sectors are projected to experience a **35 per cent reduction in asset value**. These sectors and many others must either alter their business models fundamentally or risk becoming unviable.

To align with net zero commitments and reduce their exposure, banks and insurers plan to reduce their lending to carbon intensive sectors over the next three decades, with the largest reductions in the mining and quarrying sector (see chart below). Considering estimates that financial markets are currently aligned with a dangerous 3°C of global warming, banks and insurers will arguably have to act faster to change their lending patterns.

Out of scope of the CBES were climate-adjusted capital requirements. These would require banks exposed to high levels of climate risk to hold a minimum amount of loss absorbing capital. The Bank of England will explore the case for capital requirements in a separate review.

With early action, banks and insurers identified economic sectors with investment opportunities. Participating institutions plan to increase investment in sectors, such as electricity and gas supply, construction, water supply and trade of vehicles.



(Source: Bank of England's results of the 2021 Climate Biennial Exploratory Scenario (CBES))

Next steps

From the outset, the Bank of England has indicated that the CBES was an exploratory scenario designed to improve understanding of climate-related risk management. Its findings will:

- inform the Financial Policy Committee's thinking about financial stability policy as well as the Prudential Regulatory Authority's supervisory policy;
- be shared with the government and international counterparts;
- set up the Bank of England's second round of the CBES, launched in February 2022; this will take a deeper look into the strategic response of banks and insurers to climate scenarios and implications for their business models.

The Bank of England has indicated that it will support the government – the primary lever – in driving forward the net zero transition. Therefore, MPs have an important role in scrutinising its regulatory policy and advocating for the government to go further and faster to decarbonise the economy.

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