Policy-induced transition risks

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5 discussion points on policy-induced transition risks for financial actors

1. Why is the management of policy-induced risks unavoidable in finance?

2. What impacts climate-related issues may have on the financial system?

3. What are the different policy-induced risks?

4. Why is early integration in financial practices highly advisable?

5. How can research contribute to financial policy-induced risk management?
1. Why is the management of policy-induced risks unavoidable in finance?

- The exposure of the financial system to CC Risk and ET Risks is correlated in the long-run: exposure to one; or the other; or both if action is delayed
- The cost of acting too little, too late to solve the global climate issue is very high (BoE, ESRB, Stern, etc.)
- Paris Agreement Article 2.1c puts us on track with a 2°C/1,5°C pathway.

(Source of the graph: it is from a Bruegel policy brief, based on Bank of England – Prudential Regulation Authority (2015) “The impact of climate change on the UK insurance sector”)
2. What are the impacts of climate-related issues on the financial system?

- Climate issues will impact financial actors performance and resilience: which present both risks and opportunities for financial actors
- Figure presents a synthesis of all climate-related financial impacts, from FSB TCFD (Taskforce on Climate Financial Disclosure) report published on wednesday
- Risks: transition and physical risks -> discours Mark Carney
- Opportunities: new markets are emerging (or going to emerge): champions will be those succeeding in capturing those opportunities
- Those risks and opportunities will have either positive of negative impacts on the financial performance of firms, both on their Income Statement and their Balance Sheet:
  - Income Statement: increased revenues for those capturing ET opportunities ; increased expenditures, for examples increased taxes
  - Balance sheet : risk of assets write-off (stranded assets)

(Source: the FSB Task Force report was released on Wednesday.)
3. Different types of policy-induced transition risks?

Policies on ET impacting financial actors may be both direct (policies on financial activity, such article 173) and indirect (policies impacting financial actors’ underlying assets).

Indirect policy-induced risks go beyond carbon pricing, and may also involve different policy instruments, such as State ban on specific products, standards (such as carbon performance of vehicles) and regulatory support to ET-aligned assets (RD&D support and competitiveness, e.g. subsidy to buy an electric car).

=> all these policies entail market transformations and comparative changes in the financial performance of firms in one sector.

- Different policy tools lead to different impacts in terms of abruptness and spread across economic actors (in the case of bans and standards, only actors/activities that have not anticipated policy and market changes will be impacted, while in the case of carbon pricing all actors are impacted gradually depending on their efforts to reduce carbon emissions – important: répond à demande Jean Boissinot)

- Policies on the real economy affect risk-adjusted return through final impacts on margin and balance sheet, and also depending on the characteristics of the financial title, the position of the financial actor in the capital stack and their portfolio strategy (e.g. buy and hold; buy and sell).

- Challenge: translating impacts of policies to financial assets and portfolios (thus...
there is no more detail on the arrow from “financial and real assets” to “financial system”. 
4. Why is early integration in financial practices highly advisable?

- Point 1: ET policies may impact almost all sectors, it is not just a fossil-fuel vs RE transition => impacts on the majority of assets in financial actors’ portfolios

- Point 2:
  - Step 1: Transition phase → ET supporting policies are still seen as a risk to the carbo-intensive frame perceived to remain stable. This may be reinforced by uncertainty about unprecedented change.
  - Step 2:
    - This transition is to lead to a new economic model with new winners and losers, with no going back to the old framework: not perceived as transition policy-induced risks anymore, but the new BaU economic model.

=> Then financial actors can benefit from integrating now climate issues in a way that allows for risk management and catching opportunities of this upcoming economic structure.

- The open question is: when and under which conditions can financial actors perceive the ET-supporting policies as the new
BaU?
5. How can research contribute to catch the potential of policy-induced risk management?

• Point 1:
  - Are policy-induced risks correctly assessed with current modeling tools?
    - Risk models (VaR with confidence thresholds for accounting losses; stress-testing practices)
    - Valuation models and the risk premiums to green and brown assets: are they justified?
      => Does current evaluation of risks reflect well risk levels in a low-carbon economy?
    - How can financial regulations influence the assessment and management of risks?

• Point 2:
  - Unprecedented structural change cannot be foreseen based on history (driving with the rear view mirror)
  - Recognizing the need for forward-looking analysis implies to perceive the energy transition as credible
  - How can the scenario become something credible and attractive?
- Strong signal to catalyze the restructuration of the economy?
- Potential additional market failures to overcome for concrete action?

- When perceived as credible, how to proceed forward-looking analysis:
  - Including various types of change: shocks (*hairpin turn*) and gradual (*steep turn*)
  - Including various policy timelines (*distance information under panels*)
  - Treating uncertainty as part of the problem (which is incompatible with optimal choice models)

- When acknowledged that the transition is not an anecdotic regulatory issue, the question of macro models:
  - how to model at the macro level the structural change in the economy, with a perturbation leading to a new state of the system?

• Laurents Clerc mentioned on Friday’s Séminaire Chaire E&P that it is not the role of the prudential system to guide financial flows towards an selection of sectors.

→ I4CE’s argument: redirecting financial flows to the energy transition is not limited to the question of financial flows to FF vs RE in the energy sector. This is first a matter of financing the whole economy in structuration towards an LCCR model.
Thank you for your attention
Questions, comments?

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