White Paper

ACTION REQUIRED: TRANSITION RISKS IN THE FACE OF CLIMATE CHANGE

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ACTION REQUIRED:
Transition Risks in the Face of Climate Change

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As global greenhouse gas emissions soar to unprecedented levels and the world grapples with the urgent need to transition to a low-carbon economy, the implications for financial institutions, including community banks, cannot be ignored. Transition risks stemming from policy and legal changes, technological advancements, market shifts, and evolving consumer and investor sentiment are poised to reshape the business landscape. While it may be tempting to dismiss these risks as distant concerns, the truth is that they hold significant implications for your institution's profitability and long-term viability. By proactively addressing and managing these risks, community banks have a unique opportunity to not only safeguard their financial health but also emerge as superheroes driving positive change in the face of the climate crisis. Don't wait until it's too late – embrace climate risk management and position your bank as a leader in sustainability and resilience.

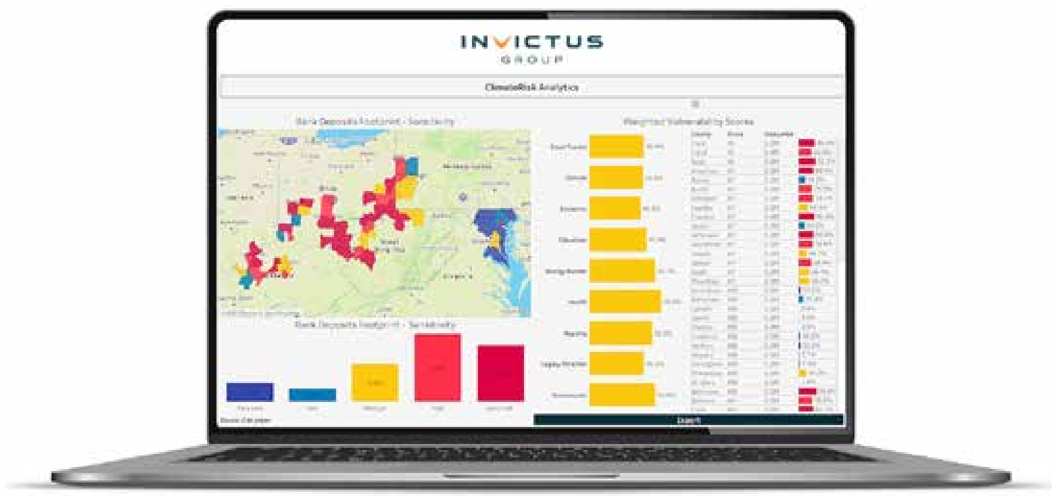
When regulators refer to physical risk from climate change, they are including damage to property, infrastructure, and business disruptions due to acute, climate-related events, such as wildfires and floods, and chronic shifts in climate, including higher average temperatures and sea level rise. Transition risk examines the implications of climate change from a different angle- the challenges and uncertainties faced by businesses and financial institutions as they navigate the transition to a low-carbon economy. It encompasses the various factors and drivers that can disrupt traditional business models, investments, and market dynamics. Transition risk highlights the need for proactive adaptation and strategic planning to ensure the resilience and long-term sustainability of organizations in a rapidly changing economic and environmental landscape.

For insurance companies, transition risk is often linked to their investment portfolios. The National Association of Insurance Commissioners explains the potential for economic and societal impacts to emerge in a much shorter time frame for transition risks than physical risks from climate change, due to the high uncertainty about the future pathways in achieving a low carbon economy. Transition risk can be broken down into four key types: Policy and Legal Risks, Technology Risks, Market Risks, and Reputation Risks, as identified by the Task Force on Climate-Related Financial Disclosures [TCFD]. Transition risks, due to their potential financial impact, could lead to the erosion of market value and heightened market volatility for specific assets, driven by shifts in how companies are perceived in terms of their role in a sustainable economy. Furthermore, these risks might influence the accessibility and cost of insurance products within particular sectors, notably those linked to fossil fuel industries, while also prompting increased expenditures for the development of technology and procedures necessary for a seamless and effective transition [NAIC].

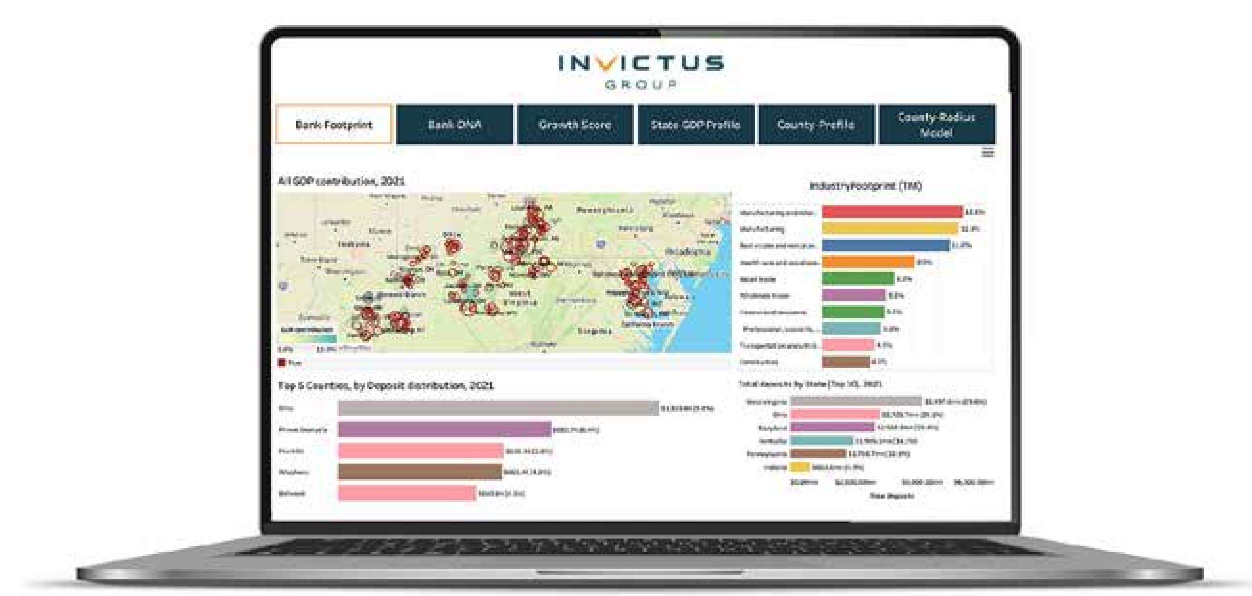
The Washington Post examines this transition for one of California's leading home insurance providers. Effective May 27, 2023, State Farm has stopped accepting new homeowner insurance applications in the state due to the increased risk of catastrophes such as wildfires and high construction costs. The decision highlights the growing threats to insurance availability and affordability in the face of climate crisis-fueled disasters. The company cited rapidly growing catastrophe exposure, escalating construction costs outpacing inflation, and a challenging reinsurance market as the reasons for its decision. The move by State Farm underscores the challenges insurers face in managing transition risks associated with climate change, particularly in regions prone to wildfires. As climate risks intensify, including wildfires, droughts, and extreme weather events, businesses alongside government regulations will need to adapt to ensure continued financial resilience [The Washington Post].

> **Many mid-sized and community banks are just beginning to think, 'where do I start in this space'?**

Community banks have a unique role to play in supporting their local communities through climate risk management. By understanding and addressing transition risks, banks can contribute to the overall resilience of the communities they serve. This involves managing risks related to climate change, energy, health, housing, legacy pollution, transportation, water and wastewater, and workforce development. These are the eight categories of burden defined by the United States Council on Environmental Quality, as used in their Climate and Economic Justice Screening Tool. By actively identifying these risks through ClimateRisk Analytics developed by Invictus Group, banks can help protect their customers, businesses, and the broader community from the economic effects of what the UN now warns is a global boiling.



These indicators of burden are used in sensitivity analysis, based on lending footprint, to identify key risk factors for a given community. As an example, a hypothetical bank in West Virginia holds 4.7 million dollars in deposits that rank at a High sensitivity to transition risk, and 3.9 million ranking at a Very High sensitivity. The majority of this weighted vulnerability score is impacted by high energy and health concerns. Energy burdens are defined as high percentile rankings for the cost of energy or the amount of PM2.5 in the air, fine inhalable particles capable of carrying harmful toxins into the lungs. Health burdens are defined as high percentile rankings for asthma, diabetes, heart disease, or low life expectancy. Facing these burdens, communities such as those in West Virginia are highly susceptible to transitions such as policy changes and technological advancements in an attempt to combat health and energy concerns. For banks supplying business to these communities, an advantageous market to tap into may be emerging, found in new companies coming in and offering low-cost energy that reduces emissions of harmful PM2.5 and consequent health effects.



Bank footprints can also be analyzed for their GDP distribution. In the above heat map model, GDP contributions can be broken down by industry. Our hypothetical bank dedicates majority of its IndustryFootprint to manufacturing and information. Manufacturing is a top contributor to global greenhouse gas emissions, ahead of the power or transportation sectors. These sectors have already begun to face transition risks, in the form of changes to policy and investments. Manufacturing, while an industry still growing along with population and developing countries, will be next to face these risks, and it is to community bank's advantage to take action now.

By taking a proactive approach, banks can lead the way in their communities, making a positive difference while also securing their financial future. Banks that prioritize climate risk management demonstrate their commitment to sustainability, resilience, and responsible business practices. This positions them as trusted partners for customers seeking financial institutions that align with their values and priorities. Climate risk management is an important strategic consideration for community banks, even if they may not currently face immediate physical risks. By becoming superheroes in the face of the climate crisis, community banks can lead the way towards a sustainable and prosperous future for themselves and the communities they serve.

Further Reading

- Task Force on Climate-related Financial Disclosures 2022 Status Report
- Center for Insurance Policy & Research: Report on climate-related financial risk
- Climate and Economic Justice Screening Tool

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