CADWALADER

Cabinet **News and Views**

Informed analysis for the financial services industry

Global Banking Regulators Plan to Develop Short-Term Climate Scenarios


By Sukhvir Basran
Partner | Financial Services


By Rachel Rodman
Partner | Consumer Financial Services Enforcement and Litigation

The Network of Central Banks and Supervisors for Greening the Financial System ("NGFS") is assembling a team of modelling experts to develop short-term climate scenarios that capture the adverse implications in the near term of disorderly climate transition efforts and natural disasters. In a Call for Expression of Interest published on May 24, the NGFS observed that short-term climate scenarios are intended to complement the NGFS's existing framework of long-term climate scenarios, and will be based on detailed narratives and recommendations around scenario design, shocks, calibration and model implementation. The NGFS plans to commence developing scenarios in the third quarter of 2023.

Launched in 2017, the NGFS is a group of 125 central banks and supervisors based on five continents that share best practices and contribute to the development of environment and climate risk management in the financial sector, and seek to mobilize mainstream finance to support the transition toward a sustainable economy. NGFS members themselves are responsible for the supervision of all global systemically important banks and 80% of internationally active insurance groups.

Experts will be charged with creating macroeconomic models that can simulate various shocks related to transition and acute physical risks. In addition, these experts will guide the NGFS in understanding the modelling output and making the data available to a wider audience.

Since 2020, the NGFS has used climate scenarios to help central banks and supervisors explore the possible impacts of climate change on the economy and the financial system. These climate scenarios explore a range of plausible outcomes:

- “Orderly” scenarios assume climate policies are introduced early and become gradually more stringent, with relatively subdued physical and transition risks.
- “Disorderly” scenarios explore higher transition risks due to delayed or divergent policies across countries and sectors.
- “Hot house world” scenarios assume some climate policies are implemented in some jurisdictions, but that global efforts are insufficient to halt significant global warming, leading to severe physical risks and irreversible impacts such as rising sea levels.
- “Too little, too late” scenarios assume that a late transition fails to limit physical risks.

Taking the Temperature: As we have observed, the European financial sector has been using climate scenarios, including those developed by NGFS, to assess the implications of unchecked climate change and “stress test” financial institutions through various time periods. U.S. financial regulators have undertaken similar assessments.

The NGFS joins the UN Environment Programme Finance Initiative (“UNEP FI”), for example, which has been using short-term scenarios for some time. In May 2022, the UNEP FI released a report exploring three climate-driven macroeconomic shock scenarios for financial institutions – a sudden rise in carbon price, a spike in oil price and a trade war.

(This article originally appeared in Cadwalader Climate, a twice-weekly newsletter on the ESG market.)