JFSA's approach to climate-related financial risk management

(Tomoko AMAYA, Vice Minister for International Affairs, Financial Services Agency, Japan, published in the Eurofi Magazine on September 7, 2022)

Financial institutions are inevitably exposed to climate-related financial risks. While the typical time horizon of financial institutions' risk management and capital planning is two to three years, climate-related financial risks are likely to materialize over a much longer time horizon, and some may materialize over a few decades or more. This suggests that financial institutions need to take more dynamic approaches in risk management considering the mid- to long-term impact of their managerial decisions, changes in their business strategy as well as changes in clients' business models. Having the capacity to absorb the loss from the existing portfolio is not enough. Sustainability of earnings is essential for resilient business in the long run.

In particular, the resilience of banks' business very much depends on how their corporate clients respond to climate change related risks and opportunities. Clients' delayed response means loss of business and increase in credit risk for banks, whereas clients' successful transition brings increased business opportunity and decreased credit risk to banks. Therefore, it is important for financial institutions to actively engage with their corporate clients and support them in addressing the challenges posed by climate change. Risk management and client engagement are both sides of one coin.

Based on this idea, the FSA published the "Supervisory Guidance on Climate-related Risk Management and Client Engagement (Guidance)" on July 12. The guidance is non-binding and provide viewpoints of supervisory dialogues between the FSA and financial institutions.

For example, with regards to "strategies and governance," the FSA urges financial institutions to fully understand the risks and opportunities of climate change both for their clients and themselves, and to develop strategies for supporting their corporate clients in addressing the challenges posed by climate change, thus enhancing the robustness of their own business and contributing to the transition to net-zero.

Viewpoints also include “identification and assessment of risks and opportunities both for own business and clients,” “support for clients’ transition and other response to climate change,” “management of climate-related financial risks,” and “provision of information to stakeholders.”

In addition, the Guidance presents approaches and cases of engagement with clients especially for the use of regional banks as reference. Financial institutions are encouraged to accumulate their knowledge of climate change and understand the effect on clients of the evolution in technologies, industries and natural environments caused by climate change. They are also encouraged to provide support to clients, such as provision of consulting and solution-delivery services, provision of funds for growth, and provision of area-wide support with enhanced collaboration among stakeholders.

Let me present one of the cases in the Guidance.
Corporate clients, especially SMEs, often do not recognize the potential impact of the transition to net-zero, including the impact of decarbonization on the local economy and the impact of supply chain restructuring on their own business. Therefore, one regional bank proactively offers support to its corporate clients based on its own analysis.

The bank first narrowed down the target industries to the automobile, steel, and chemical industries based on their view on the local economic structure and analyzed the potential impact that climate change may have on the current advantages of the region as a center for those industries. The bank further assessed the impact on clients sector by sector. For example, risks increase for one client as it is affected by the shift to EVs, while business opportunities increase for another, which is engaged in the maintenance and repair of plants.

Then, the bank developed an action plan listing solutions for their clients and the regional economy to benefit from potential opportunities. Based on the plan, the bank has been having discussions with clients to identify their needs and offering solutions, such as provision of funds and human resource matching services.

Financial institutions' initiatives of proactive engagement with customers have already begun. Furthermore, for industrial sectors involving multi-layered supply chains, such as the automobile industry, a successful transition requires communication and collaboration among all entities from top tier makers to small and medium size suppliers, from big banks to small cooperative financial institutions. In order to facilitate such communication, a local office of the FSA, in collaboration with a local office of a relevant ministry, organized a meeting of representatives from an automobile maker, top tier suppliers and financial institutions, from big banks to small ones. The FSA urges financial institutions to engage with their clients and also facilitates such engagement.