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Bank of Canada/OSFI pilot helps Canadian financial sector assess climate change risks

OTTAWA, ONTARIO— The Bank of Canada and Office of the Superintendent of Financial Institutions (OSFI) today released the results of a pilot project on climate scenario analysis. This pilot was an important step in helping Canada's financial sector improve its ability to analyze economic and financial risks affecting financial institutions that could arise from climate change.

Together with six Canadian financial institutions, the Bank and OSFI developed scenarios that will help the financial sector identify, measure and disclose climate-related risks. These scenarios were not intended to be forecasts or predictions. Rather, they were specifically designed to capture a range of potential outcomes and illustrate the kinds of stresses on the financial system and economy that could occur as the world transitions to a low-carbon future.

All scenarios showed that this transition will entail important risks for some economic sectors. Mispricing of transition risks could expose financial institutions and investors to sudden and large losses. It could also delay investments needed to help mitigate the impact of climate change.

The scenarios highlighted that meeting climate targets will lead to significant structural changes for the Canadian and global economies, and that this transition will be more challenging in countries like Canada that have large carbon-intensive sectors. As well, the analysis showed that delaying climate policy action increases the overall economic impacts and risks to financial stability. In the scenario analysis, the economic impacts for Canada are driven mostly by declines in global commodity prices.

An important caveat is that the scenarios make very conservative assumptions about the evolution of green technologies. Therefore, they do not capture potential disruptive technology impacts or opportunities. The scenarios also deliberately focus on transition risks rather than physical risks. The manifestation of physical risks, and efforts to avoid or mitigate their impact, could also have significant implications for the global and Canadian economies and the financial system. This is an area for future work.

Scenario analysis is a better tool to use for this work than traditional economic models because climate change is global and complex and the risks involved have very long time horizons. Further, there is a large amount of uncertainty about how emerging technologies and policies will evolve to address climate change.

The pilot, which was launched in late 2020, built on work by the Central Banks and Supervisors Network for Greening the Financial System (NGFS)—a group of more than 100 members that defines and promotes best practices in climate risk management in the financial sector. The Bank of Canada joined the NGFS in 2019, and OSFI joined last year. While the NGFS pioneered the use of scenario analysis to examine climate change risks, the pilot extended that work by looking at potential impacts on specific economic sectors.

The pilot also provided insight on the maturity of climate related governance and risk management practices of Canadian financial institutions, and their level of preparedness for managing risks. More robust management of climate related financial risks is essential for institutions to better understand how they are exposed to climate change under different potential scenario pathways.

Both the public and private sectors are in the early stages of building their capacity to assess risks related to climate change.

In the future, it will be important to work toward better data collection on exposures and vulnerabilities and for more institutions to employ scenario analysis. Future work could consider, for example, physical risks related to climate change, other types of risk, or larger systemic considerations.

For its part, the Bank of Canada plans to build its capacity to assess the implications of more frequent severe weather events and the transition to a low-carbon economy for potential output growth, the labour market and inflation, while OSFI announced today in an industry letter that it will issue draft guidance on climate risk management for federally regulated financial institutions later this year.

Quotes

“Climate change will have broad economic and financial impacts, so the Bank has committed to develop new models and methods to better understand physical and transition effects on the Canadian economy. This pilot illustrates how the public and private sectors need to work together to ensure our economy and financial system are adequately prepared to handle the transition to a low-carbon economy.”

- Toni Gravelle, Deputy Governor, Bank of Canada

“Climate scenario exercises, like this one, make clear the potential financial impacts of climate-related transition risks across a range of different climate pathways. This work is a critical step toward building risk management capability and awareness among regulated entities and thereby promoting financial resilience through the transition.”

- Ben Gully, Assistant Superintendent, Office of the Superintendent of Financial Institutions

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