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WFX DISPATCH

ADB

A Community Where Ideas, Innovation, Empowerment, and Opportunity are Shared

MITIGATING CLIMATE RISKS

In March 2023, the Intergovernmental Panel on Climate Change (IPCC) confirmed that the global surface temperature is increasing. It also warned that climate change and environmental degradation pose serious challenges to the global economy. In our seventh issue, we delve into the various facets of climate risks and explore how making climate finance work for women can be advantageous not only for financial institutions (FIs) but also for society.

LATEST FROM WFX

CLIMATE CHANGE AND FINANCIAL SECTOR

Mitigating Risks and Exploiting Opportunities

By Carola Menzel, Sustainable Finance Specialist

The Asia and Pacific region has a high level of vulnerability to climate threats which can have consequences for health, business operations, assets, and supply chains. The financial sector, too, is vulnerable to climate and environment-related risks, such as extreme weather events, and should consider these developments in their strategies and processes.

Measuring Climate-Related Financial Risks

The different forms of climate-related financial risks, including credit, liquidity and operational risks, arise from a disorderly transition to a low-carbon economy (transition risks) and from physical impacts of climate change (physical risks). Both transition and physical risks can impact financial institutions and the wider economy in a complex and interconnected way.

FIs are exposed to risks through their counterparties and invested assets, but they also have an impact on climate factors directly through financed emissions or other types of pollution.

Assessing and categorizing risks at portfolio level and during credit-granting processes help FIs to allocate risk mitigation solutions. However, the process of measuring climate risks has several challenges, such as uncertain timings of climate-related events and scarcity of comparable and reliable data. To overcome those challenges, FIs may consider three approaches.

- The **portfolio alignment method** supports the alignment between the institution's portfolio and global targets such as the goal of the Paris Agreement to limit global warming to 2°C or below.
- The **exposure method** captures sensitivities to climate risks by assessing how individual exposures and counterparties perform on climate impact by considering sector level characteristics. These include environmental, social and governance (ESG) ratings, and evaluations provided by rating agencies and ESG scoring models.
- The **risk framework method** connects the sensitivity of portfolios and risk of losses with climate change impacts and assesses the risk of potential losses. Integrating climate risks into underwriting and credit evaluations through climate risk screening and vulnerability assessments helps FIs to test the resilience and financial robustness of counterparties. A climate risk heat map illustrates vulnerability and potential risks of portfolios and new deals.

Mitigating Climate-Related Financial Risks

Risk mitigation can be addressed in various forms, such as transferring risks through climate risk insurance for businesses which are directly dependent on weather conditions. It could also be addressed by diversifying portfolios, thus reducing the FIs' exposures to at-risk sectors. For at-risk sectors, sector specific liquidity buffers are an option to mitigate liquidity risks. The implementation of an exclusion policy supports divestments of high-risk sectors.

For sectors highly vulnerable to climate policies, such as CO2-intensive industries, institutions can limit the tenor and align prices. For example, a premium can be placed for companies that are realizing ambitious carbon reduction or elimination targets. FIs can also require a sustainable transition strategy for such industries. Setting sector-specific credit limits in line with climate-related objectives and integrating respective indicators in lending criteria further reduces operational risks.

Eventually, when managed well, climate risks can also be translated into business opportunities. For instance, establishing sustainable finance instruments, such as dedicated loans with clear climate goals, can help FIs to diversify portfolio and to align with national climate objectives, while strengthening clients' resilience and ability to comply with regulations and respond to transition risk. Ideally, sustainable finance instruments should be implemented with a gender lens as increasing empirical evidence suggests that women are more impacted by climate change than men. Doing so will help FIs contribute positively to SDGs 5 (Gender Equality) and 13 (Climate Action).

WFX is supporting FIs in their efforts to be "greener" in their lending activities and enhance their ability to assess climate change risks within their lending portfolio. The capacity building initiatives aim to strengthen FIs in ensuring (i) compliance with national and international standards in sustainable finance, (ii) accurate reporting, and (iii) availability of suitable green lending products to serve its SMEs, including women.

SUPPORTING WOMEN-OWNED BUSINESSES WITH CLIMATE FINANCE BENEFITS EVERYONE

By Carola Menzel, Sustainable Finance Specialist

Women and girls are disproportionately challenged by climate change. But the barriers they face in accessing resources and decision-making opportunities restrict their ability to respond. Although greater access to sustainable and gender-equitable green finance will help women address climate change, women entrepreneurs often face financing gaps, especially in the realm of sustainable finance. Usually, women are loaned small amounts of money for one-off green investments. This is limiting their opportunity to make a difference in fighting the impact of climate change and in building climate resilience.

Evidence shows that investing in women makes economic sense. In one report, it was written that compared to men, women borrowers have 1% - 3% lower default rates in almost all loan product categories. Research also shows that women are often the front runners in developing strategies to cope with climate change. FIs can therefore facilitate the process of improving gender equality in climate finance while realizing financial returns by addressing climate risks. FIs can diversify and offer dedicated financial products to facilitate climate actions that contribute to lessen operational expenses, e.g., energy savings through optimized processes and systems, and offering efficient/ low-carbon or resilient products and services, both of which increase returns while addressing climate risks. However, FIs would need to make some adjustments within their systems to achieve this.

To begin with, the risk management and selection criteria should address climate risk and include gender-sensitive data, including women's differentiated needs and priorities. Additionally, product design and the use of technology should respond to gender-specific barriers, empower women, and increase time and cost efficiency when accessing finance.

When categorizing gender-related use of proceeds, global frameworks for sustainable bonds can be referenced as a source of guidance. Helpful guidance and tools are available that can guide FIs to incorporate women's economic empowerment and gender equality. For instance, the UNEP's Finance Initiative's Guidance on Gender Equality Target Setting encourages FIs to integrate gender targets in overall commitments to climate change. Addressing climate change requires full participation and empowerment of women, and FIs can play an important role in this process by integrating gender-sensitive data, product design and technology.

BACK TO MAIN

ASSESSING CLIMATE RISKS THROUGH CLIMATE SCENARIO ANALYSIS AND CLIMATE STRESS TESTING

Traditional risk assessment methods are challenged by the distinctive characteristics of climate risks. But climate stress tests have emerged as an effective tool for FIs to measure the degree of exposure to climate risk. FIs measure short- and long-term risk drivers of businesses by applying scenario analysis and determine the potential effects of climate change on a given portfolio by simulating severe climate hazards. Incorporating climate change scenarios in the stress-testing process, such as the ECB Economy-wide Climate Stress Test, enables the FIs to ensure the capital required to maintain operations during adverse climate scenarios or policy shocks.

While there are many climate change scenarios, the Network for Greening the Financial System's (NGFS) scenarios are mostly used by FIs to understand the economic impacts of their businesses. NGFS' latest release contains six scenarios in three groups: (i) orderly transition - Net zero 2050, Below 2, (ii) disorderly transition - divergent net zero, delayed transition, and (iii) hothouse world - nationally determined contributions, current policies. Following climate stress-test and scenario exercises, different entities such as NGFS, European Insurance and Occupational Pensions Authority, and ECB highlighted that a disorderly and delayed transition has higher costs than an early and smooth transition.

DECARBONIZED ECONOMY DEPENDS ON THE TRANSITIONING OF MSMEs

Transition finance is a concept where financial services are provided to high carbon-emitting industries to fund decarbonization. Although dominated by large corporates, transition towards decarbonized economy cannot be achieved without transitioning medium, small, and micro-sized enterprises (MSMEs) in their value chains. FIs have a catalytic role in this process. Surveys of SMEs found considerable barriers, with one estimate suggesting a $50 trillion SME transition finance gap. Despite women owning one third of the businesses globally and being more likely to take climate considerations in business decisions, women entrepreneurs find it difficult to access climate finance. WFX will build on the existing limited literature to guide financial institutions and other stakeholders on bridging the MSME transition finance gap while ensuring gender-responsiveness.

Links to Resources

Why Investing in Women Makes Economic Sense
Viet Nam Study (https://www.adb.org/sites/default/files/publication/850891/financial-access-women-owned-smes-viet-nam.pdf)

PRC Study (https://www.adb.org/sites/default/files/publication/513371/adbi-wp977.pdf)
International Labour Office Study, Small change, Big changes: Women and Microfinance (https://www.ilo.org/wcmsp5/groups/public/---dgreports/---gender/documents/meetingdocument/wcms_091581.pdf)

ADB, 2021, Unlocking private investments (https://blogs.adb.org/blog/unlocking-private-investment-drive-positive-change-for-women-in-asia-pacific)

Womens World Banking, 2020, Annual Report. (https://www.womensworldbanking.org/wp-content/uploads/2021/11/2020-Annual-Report.pdf)

Financial Innovation for SME Net Zero Transition: Role of Banks and Buyers (https://www.cisl.cam.ac.uk/files/financial_innovation_for_sme_net_zero_report_03-23.pdf)

ASEAN and Global Value Chains: Locking in Resilience and Sustainability (https://www.adb.org/publications/asean-global-value-chains-resilience-sustainability)

IPCC Sixth Assessment Report: Impacts, Adaptation and Vulnerability (https://www.ipcc.ch/report/ar6/wg2/)

Towards Climate-related Statistical Indicators (https://www.ecb.europa.eu/pub/pdf/other/ecb.climate_change_indicators202301~47c4bbbc92.en.pdf)

Time to Get Serious About the Realities of Climate Risk (https://www.pwc.com/gx/en/services/sustainability/publications/risks-and-opportunities-of-climate-change-on-business.html)

Why Climate Change Matters for Women (https://data.unwomen.org/features/why-climate-change-matters-women#:~:text=If%20droughts%20continue%20to%20increase,as%20a%20loss%20of%20agency)

WAYS TO SUPPORT WOMEN FARMERS TO DRIVE RESELIENCE

Climate change induced changes in temperature and rainfall patterns, along with more frequent and severe weather events and biodiversity loss, threaten agricultural livelihoods, particularly for smallholder farmers who are often women. Almost 40% of all agricultural workers in crop, livestock, fisheries, and forestry production are women worldwide. Many FIs with an exposure to the agricultural sector can already observe the high vulnerability to climate change.

Studies have found that gender inequalities in access to land rights, finance, inputs, and agricultural extension services can prevent women from implementing adaptive practices. The Consortium of International Agricultural Research Centers (CGIAR) proposes six steps to support women farmers to drive resilience.

- Target private and public climate investments toward women who need it most.
- Provide productive resources and labor-saving technologies to women.
- Design climate information services to reach and benefit women.
- Support women's collective action for increased resilience.
- Promote women's leadership and participation in decision-making at all levels.
- Collect gender disaggregated data.

WHAT'S HAPPENING AT WFX

WFX KNOWLEDGE EVENTS

WFX organized a virtual roundtable on 22 June to discuss the advent of cloud technology and its impact on FIs. Participants comprised ADB's FI partners that are not yet using cloud services or are at a nascent stage of usage. Discussions focused on the needs of FIs transitioning to the cloud services and the best way of optimizing potential benefits.

WFX has a lineup of knowledge events around gender, technology and green finance planned for this year. Please visit our website https://www.wfx.adb.org/ for details.

DIGITAL AND FINANCIAL LITERACY TRAININGS FOR WOMEN ENTREPRENEURS

WFX provided virtual trainings to some 200 women entrepreneurs in May and June 2023 to help them understand and navigate the financial system and use financial services effectively. The trainings focused on financial and digital literacy and e-commerce. Women SME owners from Fiji, Vanuatu and Solomon Islands participated in the trainings that was supported by the Women Entrepreneurs Financing Initiative (WeFi).

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