Climate Risks | How Far Will They Affect Credit?

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Climate transition and physical risks may be among the most significant ESG credit factors influencing the creditworthiness of rated entities next year.

How this will shape 2022

Elevated unmitigated exposure to climate risks will continue to affect credit quality. The past year has seen an unprecedented number of rating actions triggered by disruption and uncertainty over unexpected costs from severe climatic events, such as hurricanes, wildfires, and droughts. In September 2021 alone, five out of 14 ESG-driven rating actions in U.S. public finance were linked to physical climate risks. This trend will likely escalate as global temperatures continue to rise, leading to erratic weather patterns affecting real assets and infrastructure in particular.

Growing awareness of physical climate change risks could encourage a faster transition to net zero. Following the COP26 Climate Change Summit in late 2021, governments are considering a wider range of policy tools, including market mechanisms, to support ambitious pledges aimed at achieving carbon neutrality by 2050. The costs of the transition to net zero may become more material. Our scenario analysis assuming a $100 per ton carbon tax found the effect on China's GDP would be four times higher than EU GDP by 2030. This is because China relies on more carbon-intensive sources of energy to support growth.

Efforts to standardize ESG reporting will continue to gather momentum. As many countries target a green recovery following the pandemic, banks and insurers have a key role in supporting the agenda through the way in which they allocate capital and underwrite, presenting an opportunity for significant growth and returns.

We expect the rest of the financial reporting ecosystem to follow in mandating task force on climate-related financial disclosures (TCFD). Financial disclosures will likely become more robust and, as the materiality of climate risks escalate, such risks will top the enforcement agenda, including by the European Securities Market Authority.

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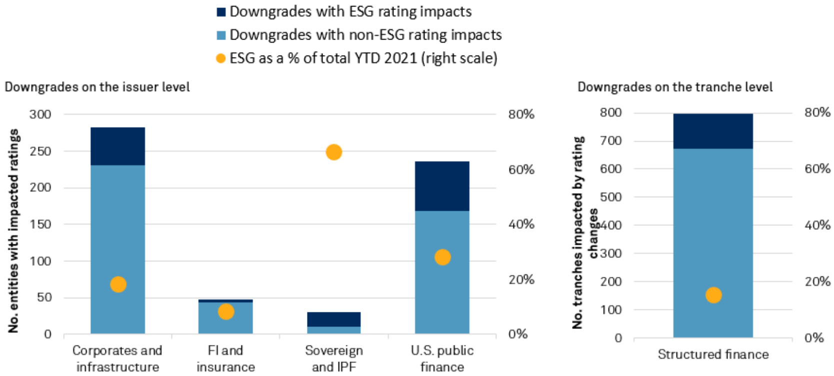
Green Spending Or Carbon Taxes (Or Both): How To Reach Climate Targets, And Grow Too, By 2030? Nov. 4, 2021

Chart 56

ESG Versus Non ESG-Affected Downgrades (January-October 2021)



Source: S&P Global Ratings. Note: Includes downgrades from January to October 2021. Entities reflect issuers (ultimate parent only without subsidiaries), except for issues/tranches for structured finance. Multiple rating actions are only counted once.

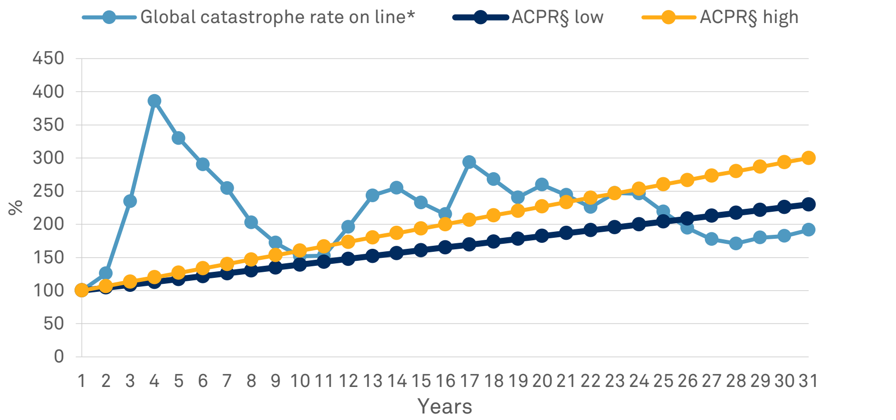
What we think and why

Combining policy tools could soften the hit to economic growth. Green public spending, regulation, and carbon taxes in the U.S., EU, and China could provide important assistance to the most vulnerable sectors and households. However, current commitments are unlikely to reach more ambitious climate targets.

Green public spending could boost EU and U.S. GDP by 6.6 percentage points (pp) and 2pp, respectively, by 2030. Green stimulus measures are taking place during a time of economic slack and low financing costs, which means that the fiscal multiplier--and therefore the potential for economic growth--are at their highest.

Chart 57

Historical Catastrophe Rates Demonstrate The Challenge Reinsurers Face In Relying On Annual Repricing To Reflect Physical Climate Risk



Source: Guy Carpenter, Autorité de contrôle prudentiel et de resolution, S&P Global Ratings
*Guy Carpenter: Global Property Rate on Line Index (1990-2020). §ACPR (Autorité de contrôle prudentiel et de resolution): Estimate on premium increase necessity of about 130%-200% from the stress test result for catastrophe business in France over 30 years.

What could go wrong

Current policies are not sufficient to stay within of 1.5 degrees of warming, according to scientists. While they could avoid the worst climate change impacts, more aggressive policies could offset some of the positive growth effects of current policies, especially in countries reliant on carbon-intensive energy sources and at an earlier stage in their transition.

Carbon taxes are likely to have a negative impact on growth. While carbon taxes may be the best policy lever to tackle environmental problems, they may cause more direct economic losses, especially for lower-income households and smaller firms if not offset. This is in contrast to green spending, which is growth-enhancing.

What Could This Mean For Reinsurers?

Reinsurers' risk is currently underestimated. Our scenario analysis suggests that reinsurers' estimates of their exposure to physical climate risk could be underestimated by up to 55%--91% of the sector's buffer above the 'AA' capital requirement. This illustrates significant potential for earnings and capital volatility.

Exposure to physical climate risk is a key factor in our ratings on 19 of the top 21 rated reinsurers. Companies that take a more proactive approach to understanding and adapting their exposure to climate risk will be better protected against future capital and earnings volatility linked to climate-related losses.

The reinsurance industry's ability to reprice for the risk of climate change may not be sufficient. To offset the capital burden, they would likely need to increase natural catastrophe premiums. But they may find it difficult to be responsive enough, particularly in a largely commoditized market with differing viewpoints on the adequacy of pricing for physical climate risks.

Global Reinsurers Grapple With Climate Change Risks, Sept. 23, 2021

This report is an extract from "Global Credit Outlook 2022: Aftershocks, Future Shocks, And Transitions", Dec. 1, 2021.

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