Banking on resilience: Preparing our financial system to face natural disasters

The third report in the IESE-CEPR *Future of Banking* series provides the latest perspectives on how resilient the financial system is to natural disasters and climate change-related events and what can be done to improve its resiliency.



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- **Climate change and associated natural disasters will undoubtedly cause severe disruption to the global financial system without the implementation of adequate prevention and mitigation strategies.**
- **A combination of public intervention and private sector mitigation**

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strategies will be required to price and hedge the long-term implications of climate-related events.

- **Climate risk should not be measured through short-term horizons and there must be an internationally coordinated response to a global issue.**

The COVID-19 pandemic has exposed severe vulnerabilities in the global financial system and serves as a cautionary tale for the potentially devastating effects that future natural disasters and climate change could cause to the world economy. The question of whether society is adequately prepared -- and what measures can be put in place to mitigate these risks -- has never been more pertinent.

A new report from IESE and the Centre for Economic Policy Research (CEPR) tests how resilient the financial system is to natural disasters and discusses what can be done to make it more resilient. It details how to reshape central bank policies to address climate-related risks, debates the role of asset managers in dealing with natural disasters and climate risk, and explains why mitigation is a form of self-insurance to limit the systemic risks of global warming.

Three key messages

The risks involving natural disasters and climate change are large and complex. As a result, they require a broad range of players and tools to manage them. Fighting climate change will require a combination of public intervention and private sector mitigation strategies to price and hedge the long-term implications of climate-related events. Carbon abatement proposals should include net-zero commitments made by governments and companies to decarbonize the economy. And sustainable finance mandates, backed by financial intermediaries, should be introduced to incentivize firm efforts toward decarbonization.

Three key messages emerge from the report, which was co-written by Patrick Bolton, Marcin Kacperczyk, Harrison Hong and Xavier Vives.

1. Central banks must play a proactive role in promoting mitigation policies and coordinating climate risk policies consistent with government mandates, the private sector and civil society.
2. Asset managers can facilitate the management of climate risk and promote green financing through hedging and engagement with mitigation. Financial markets and asset managers could discipline market participants to stimulate mitigation efforts by the real sector.

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3. Investments in climate mitigation -- such as incentives for firms to adopt decarbonization technologies and reach net-zero targets -- could have positive effects on stock valuations and for climate risk-management responses similar to the rapid development of vaccines to combat the pandemic. To this end, clear financial commitments and the enforcement of stringent standards to combat climate change are essential.

The COVID-19 pandemic should serve as a stark warning that the financial sector -- from firms to central banks -- must act now to ensure future stability.

The Future of Banking series

The May 2021 report is the third installment in *The Future of Banking* series, which is part of IESE's Banking Initiative and is supported by Citi. Read about the two previous reports: **COVID-19 crisis to alter banks' business models (2020); Is our banking system sound at last? (2019).**

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