MFSA MALTA FINANCIAL SERVICES AUTHORITY

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Climate Change: MFSA Assesses Implications of Carbon Taxation

The Malta Financial Services Authority (MFSA) has published its contribution to the growing literature on climate transition risk by estimating the short-term implications of the introduction of a hypothetical carbon taxation on the stability of the Maltese financial system.

The research, conducted by the Financial Stability function, within the MFSA, found that investment portfolios appeared, on the whole, to be resilient to carbon taxes, assessed at six different taxation rates, although a few institutions could experience noteworthy losses. The tax rates considered were: $10, $20, $50, $75, $100 and $200 per ton of CO2 emitted.

The study focused specifically on the climate transition risk which could arise from the investments held in the portfolio of banks, insurance undertakings and investment funds licensed in Malta. In all of the six scenarios, the equity asset class was impacted the most should this carbon tax be introduced, followed by Collective Investment Schemes. Bonds tended to be less affected given that a tax is expected to have a small impact on the probability of default in instruments having a short-term maturity.

The authors of the report noted that taking into consideration other assets held within the financial sector, such as the loan portfolio, could result in different conclusions in terms of ultimate impact from transition risk.

Concerns related to the impact of climate change on the global economy and financial stability exponentially increased over the past decade. As a result of the Paris Agreement (2015), governments gave their commitment to limit the cumulative rise in global average temperature to +1.5°C compared to pre-industrial levels.

There is a general consensus that climate change risks are split into two main forms: physical risks – extreme weather events and an increase in global temperature due to the greenhouse gas emissions – and transition risks, which refers to the repercussions on the financial system of measures adopted to reduce emissions.

The adoption of timely and adequate policy measures is crucial to mitigate climate change risks, since this could avoid having to resort to immediate and forceful interventions at a later stage, which would inevitably harm the financial system through a disruptive shift to low-carbon assets.

The former strategy would allow market participants to perform smooth adjustments within their investment and business strategies to accommodate the changes without experiencing major losses, while the latter may trigger volatility in financial markets, possibly leading to a fire sale of carbon-intensive assets. The losses incurred in this 'disorderly' scenario might be amplified in a highly interconnected system.

Assessing climate risk over a short-term horizon can be used to identify the financial institutions' resilience and vulnerabilities to climate risks. Although the short-term approach does not lead to the same comprehensive conclusions achievable under more sophisticated and long-term analyses, it indicates the level of urgency and prioritisation in terms of policy intervention.

Looking forward, future studies will attempt to address gaps, for example by expanding the study to include the carbon footprint of the banks' loan portfolio, delving into the companies' trade-off between business model sustainability and absorption of any possible future carbon taxation policy.

Furthermore, it would be beneficial to link this climate change analysis to possible contagion risk within the financial system. The MFSA will continue to analyse climate-related risks with the objective of assessing their implications for the Maltese financial system.

Read the full report here.

About MFSA

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