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Climate Scenario Analysis in Investment Banking: Data Engineering Solutions for Future-proofing Portfolios

Rohit Nimmala

Data Engineer, NC, USA

Abstract As the financial industry grapples with the increasing impacts of climate change, investment banks are turning to advanced data engineering solutions to conduct robust climate scenario analyses. These analyses aim to quantify the potential effects of climate risks on investment portfolios and inform strategies to mitigate those risks. This white paper explores the role of data engineering in enabling granular, forward-looking assessments of climate-related risks and opportunities. We discuss best practices for data integration, model development, and scenario generation, drawing upon industry case studies. Furthermore, we present a framework for incorporating climate scenario analysis insights into investment decision-making processes to future-proof portfolios. By adopting the data engineering approaches outlined in this paper, investment banks can enhance their resilience to climate-related financial risks and position themselves for long-term success in a transitioning world.

Keywords Climate Scenario Analysis, Investment Banking, Data Engineering, Machine Learning, Risk Assessment, Stochastic Modeling, Big Data Analytics, AI-driven Insights, Feature Engineering, Model Validation

1. Introduction

The financial sector faces substantial challenges and opportunities because of climate change. Investment banks encounter the intricate challenge of evaluating and controlling climate-related risks across a wide range of portfolios that encompass various industries and geographical locations. The conventional methods of risk management, which heavily depend on past data, are inadequate in capturing the dynamic and non-linear characteristics of climate risks. Using forward-looking scenario analysis has become crucial for investment banks to conduct stress tests on their portfolios considering potential climate futures. Data engineering is a fundamental component of conducting practical climate scenario analysis. Efficient collection, processing, integration, and analysis of substantial volumes of structured and unstructured data from diverse sources are imperative to derive actionable insights. The dataset encompasses a broad spectrum, encompassing financial and environmental metrics at the company level, as well as macro-level indicators related to climate and socioeconomic factors. Using sophisticated data engineering methodologies, such as big data architectures, machine learning, and cloud computing, is imperative in effectively managing the substantial volume, diverse range, and rapid pace of climate-related data. This section provides an in-depth exploration of the fundamental elements comprising a data engineering framework designed for climate scenario analysis in investment banking. This study investigates various strategies for data sourcing and integration, model development approaches, scenario generation techniques, and the utilization of insights in investment decision-making. In conclusion, this paper examines the potential for investment banks to utilize the findings of climate scenario analysis to safeguard their portfolios against future uncertainties and align with the ongoing shift towards a low-carbon economy [1, 2].

2. Data Sourcing and Integration

A comprehensive analysis of climate scenarios necessitates the utilization of diverse data inputs derived from conventional financial databases and specialized climate sources. The analysis of climate risks and opportunities is based on company-level data, including financial statements, sustainability reports, and carbon emissions disclosures. To facilitate efficient retrieval and processing, it is imperative to standardize, cleanse, and integrate this data into a centralized database or data lake architecture.

Macro-level data, such as climate projections, policy scenarios, technology pathways, and socioeconomic indicators, provide the context for top-down scenario analysis. Prominent sources of this data encompass the Network for Greening the Financial System (NGFS), the International Energy Agency (IEA), and the Intergovernmental Panel on Climate Change (IPCC). Data engineers must develop pipelines to ensure the automatic ingestion and updating of data as new versions are released.

Using geospatial data has become increasingly crucial in evaluating physical climate hazards, including the vulnerability of assets to sea-level rise, hurricanes, and wildfires. Satellite imagery, digital elevation models, and hazard maps must be processed and overlapped with asset-level data to quantify potential impacts [3, 4].

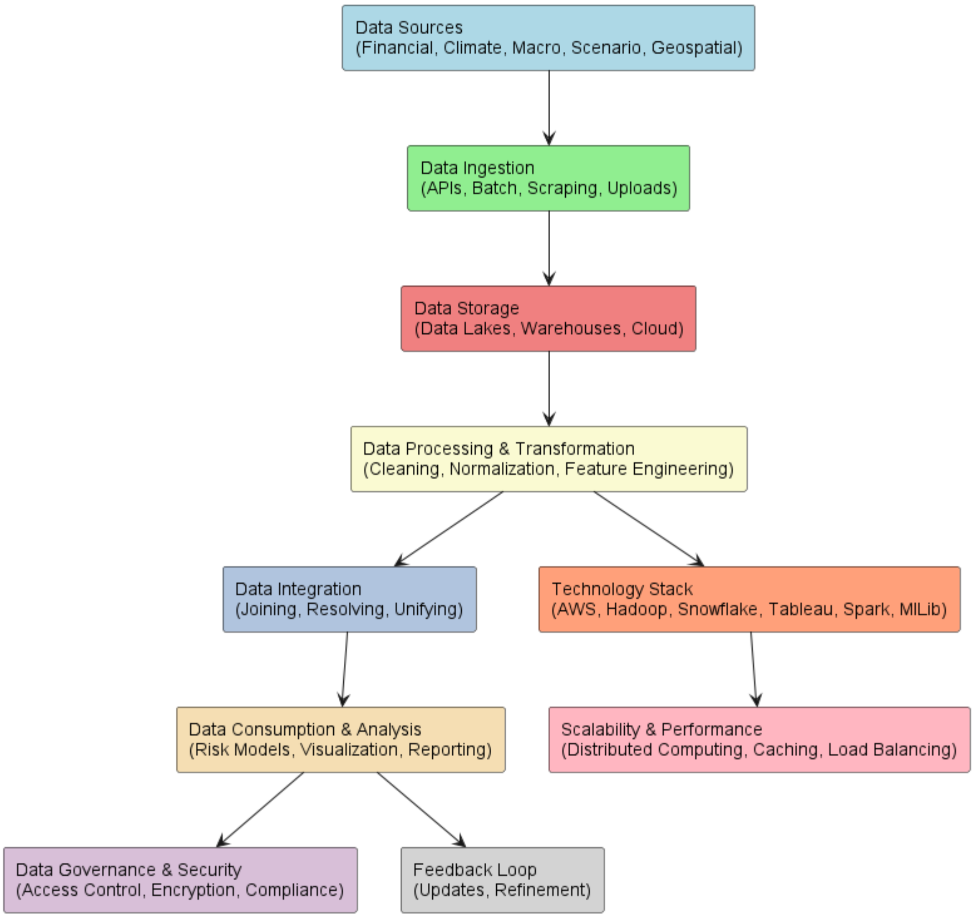


Figure 1: Data Flow Architecture for Climate Scenario Analysis

Critical considerations for data sourcing and integration include:

1. Developing a robust data governance framework to ensure data quality, security, and lineage
2. Implementing data validation checks and anomaly detection to identify and correct errors
3. Applying natural language processing (NLP) techniques to extract relevant climate-related information from unstructured sources like news articles or regulatory filings
4. Normalizing and mapping data from different sources and formats into a standardized schema
5. Leveraging cloud-based data storage and processing solutions for scalability and cost-efficiency

3. Model Development

With the necessary data inputs in place, the next step is to develop models that can translate climate scenarios into financial impacts at the company and portfolio levels. These models typically combine bottom-up, company-specific analysis with top-down, sector-level modeling.

Bottom-up models focus on how climate transition and physical risks could affect individual companies' financial performance, such as revenues, costs, asset values, and credit ratings. This requires a detailed understanding of each company's business model, geographic footprint, and carbon intensity. Analysts can use machine learning techniques to identify peer groups of companies with similar risk profiles and extrapolate impacts.

Top-down models capture the broader market and macroeconomic effects of climate scenarios, such as shifts in energy prices, consumer demand, or regulatory environments. These models often utilize computable general equilibrium (CGE) or input-output frameworks to simulate the flow of goods, services, and money between sectors under different climate constraints [5, 6].

```
function climateCreditRiskModel(portfolio, scenarios) {
  data = preprocess(portfolio)
  features = featureEngineering(data)
  for each scenario in scenarios {
    transitionRisk = assessTransitionRisk(features, scenario)
    physicalRisk = assessPhysicalRisk(features, scenario)

    pd = calculatePD(transitionRisk, physicalRisk)
    lgd = calculateLGD(transitionRisk, physicalRisk)
    ead = calculateEAD(transitionRisk, physicalRisk)

    scenarioResults[scenario] = {
      "pd": pd,
      "lgd": lgd,
      "ead": ead
    }
  }
  aggregatedResults = aggregateResults(scenarioResults)
  dashboard = generateDashboard(aggregatedResults)
  report = generateReport(aggregatedResults)

  return {
    "dashboard": dashboard,
    "report": report
  }
}
```

Pseudocode: Climate Credit Risk Model

Critical considerations for model development include:

1. Ensuring models are transparent, auditable, and explainable to stakeholders
2. Conducting sensitivity analysis to identify key model parameters and assumptions
3. Incorporating non-linear effects and tipping points, such as abrupt changes in policy or technology adoption
4. Accounting for the interactions and feedback loops between transition and physical risks
5. Implementing version control and model governance processes to track updates and maintain consistency

4. Scenario Generation

Climate-related risks and opportunities are inherently uncertain and can manifest in various ways depending on policy, technology, and market factors. Scenario analysis helps investment banks explore a range of plausible futures and stress-test their portfolios against different climate outcomes.

The NGFS has developed a set of standardized climate scenarios widely used in the financial industry. These scenarios cover three main dimensions:

1. Orderly transition - early, ambitious action to limit warming to 1.5-2°C
2. Disorderly transition - delayed, sudden, or divergent policy actions
3. Hot house world - limited action leading to significant warming above 3°C

Data engineers can use these NGFS scenarios as a starting point and customize them based on the investment bank's specific needs and risk appetite. This may involve adjusting key parameters like carbon price pathways, technology mix, or regional granularity. Stochastic modeling techniques can generate probabilistic distributions around central scenario narratives.

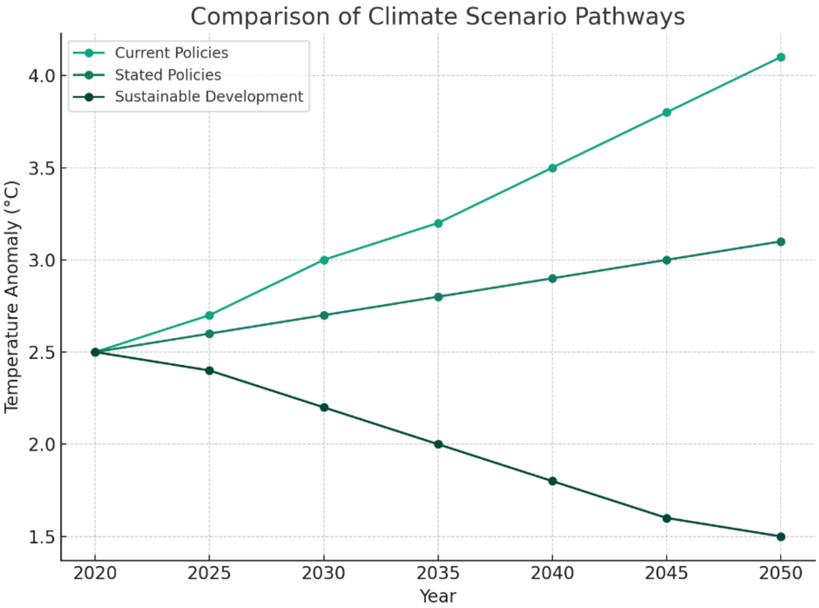


Figure 2: Comparison of Climate Scenario Pathways

In addition to transition risk scenarios, physical risk scenarios that capture the potential impact of chronic climate changes and acute weather events are essential. These scenarios can be based on global climate models (GCMs) that simulate the Earth's climate system's response to different greenhouse gas emissions pathways. Downscaling techniques can be applied to translate GCM outputs into localized projections of temperature, precipitation, sea-level rise, and extreme events [7, 8].

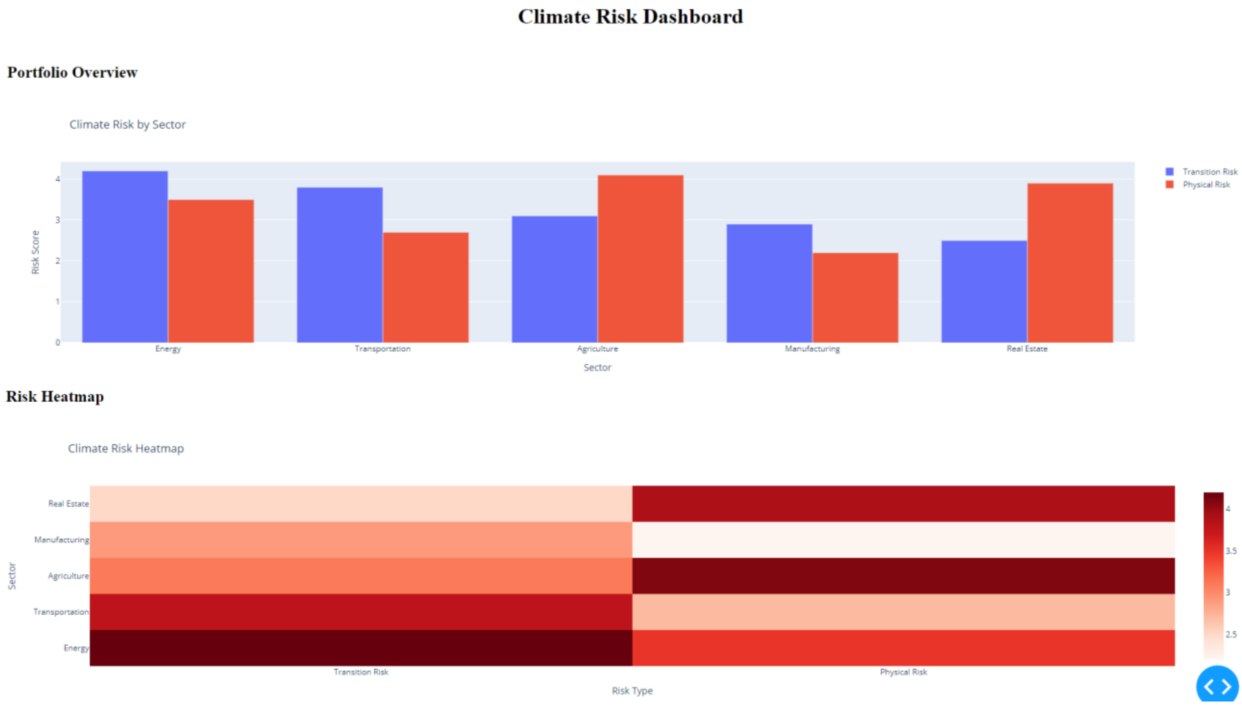
Critical considerations for scenario generation include:

1. Aligning scenarios with the investment bank's strategic planning horizons and portfolio composition
2. Engaging with internal and external stakeholders to validate scenario assumptions and narratives
3. Ensuring scenarios are internally consistent and plausible yet sufficiently diverse to capture a range of outcomes
4. Developing a standardized scenario library that can be easily updated and shared across the organization
5. Automating the scenario generation process to enable rapid iteration and sensitivity testing

5. Application to Investment Decision-Making

Climate scenario analysis aims to inform investment decision-making and help future-proof portfolios against climate-related risks. Data engineers are crucial in translating scenario insights into actionable intelligence for portfolio managers, risk officers, and executives.

One critical application is in developing climate risk dashboards and reporting tools. These dashboards provide a real-time view of portfolio exposure to various climate risk factors, such as carbon intensity, stranded asset potential, or physical hazard vulnerability. By aggregating and visualizing scenario analysis outputs, dashboards enable users to quickly identify hotspots and drill down into specific companies or assets for further investigation. Climate scenario insights can also be embedded into risk management frameworks like credit rating models, stress testing exercises, or portfolio optimization algorithms. For example, scenario-adjusted probability of default (PD) or loss-given default (LGD) estimates can be used to refine credit risk assessments and inform lending decisions. Similarly, asset allocation models can be augmented to consider climate risk factors alongside traditional financial metrics.



Mockups: Climate Risk Dashboard

On a strategic level, scenario analysis can help investment banks align their portfolios with the low-carbon transition and identify opportunities in emerging green sectors. Banks can tilt their portfolios towards leaders and away from laggards by comparing the resilience of different companies and industries under various climate scenarios. This mitigates long-term climate risks and positions the bank to capitalize on the massive capital flows required to achieve net-zero emissions by 2050.

Critical considerations for application to investment decision-making include:

1. Defining clear metrics and key performance indicators (KPIs) to track portfolio alignment with climate goals
2. Implementing governance structures and incentives to ensure scenario insights are integrated into business processes
3. Providing training and capacity building for staff to interpret and act on climate risk information
4. Collaborating with clients and investees to support their own climate risk management and disclosure efforts
5. Regularly reviewing and updating scenario analysis approaches to reflect the latest scientific, technological, and policy developments

6. Conclusion

Climate change is a complex, multidimensional challenge that requires a robust data engineering foundation to assess and manage risks in investment portfolios. By leveraging advanced techniques in data integration, model development, and scenario generation, investment banks can gain a more granular and forward-looking view of potential climate impacts. However, the actual value of climate scenario analysis lies in its ability to inform strategic decision-making and catalyze action towards a more sustainable, resilient future. Investment banks are critical in channeling capital towards low-carbon solutions and helping clients navigate the risks and opportunities of the climate transition. By harnessing the power of data engineering to measure and manage climate risks, investment banks can not only future-proof their portfolios but also help accelerate the global shift to a net-zero economy. The tools and approaches outlined in this paper provide a foundation for this transformative work.

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