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What climate risk management can teach banks about geopolitical risk

Climate change and geopolitical tensions increasingly interact, creating compound risks that can amplify shocks to banks and financial stability. ***Martina Menegat*** *and* ***Agnieszka Smoleńska*** *explain how tools developed for climate risks can inform bank supervision and improve management of geopolitical exposures.*

Climate change and geopolitical risks are closely intertwined. From shifting power dynamics in the Arctic to its effects on food security, climate change has the potential to intensify geopolitical tensions. Geopolitical tensions, in turn, can hinder effective climate action and intensify geopolitical and geoeconomic competition. The contest over critical minerals, an essential part of the green transition, risks fuelling conflict and resource nationalism, which can undermine trade and security agreements. Climate change and geopolitical risks can both amplify each other and generate their own risks to the global economy and financial stability.

How geopolitical risks and climate risks compare

Bank supervisors – tasked with ensuring the safety and soundness of banks ("prudential supervision") – are increasingly realising that geopolitical risk factors drive risk across existing risk categories. Such understanding has been growing since Russia's invasion of Ukraine.

Claudia Buch, the Chair of the Supervisory Board of the European Central Bank (ECB), described three channels through which geopolitical risks can transmit to the macrofinancial environment: the financial market channel (where they can create uncertainty and investor risk aversion); the real economy channel (heightened trade and supply chain disruptions, commodity market disruptions or economic uncertainty); and the safety and security channel (such as increased physical risk related to conflict or social unrest). These channels, in turn, can translate into risks for banks across all traditional prudential categories. For instance, credit risk arising from counterparties in high-risk countries or vulnerable sectors, and business model risk linked to concentrated exposures, license withdrawals or asset freezes and seizures.

Recent research shows that banks do not price in geopolitical risks until they materialise. Credit risk calculations in the Basel Framework, a set of rules designed to strengthen bank supervision, do cover *force majeure* events, such as wars. But there are currently no best practice measures or supervisory guidance for banks to manage geopolitical risks.

When green swans meet black

Geopolitical and climate risks share several common features. They both contain a high level of uncertainty that make them difficult to fit into existing prudential frameworks. Like climate risks, geopolitical risks are foreseeable but hardly unpredictable: they are marked by uncertainty and limited measurability. Although some data exists on how past geopolitical crises have affected financial stability (such as during phases of geopolitical unrest like the two world wars), historical experiences offer little predictive power in today's deeply interconnected global markets.

The trajectory of climate risks is more predictable, as their occurrence is increasingly certain. It is likely that they will culminate in "green swan" events: wide-ranging events affecting multiple sectors that may occur gradually or accelerate unexpectedly through tipping points. Geopolitical risks, on the other hand, are inherently uncertain and risk producing "black swan" events, which are possible, may be long or short term, and unpredictable, so that events can emerge unexpectedly and escalate quickly. And while climate risks are currently irreversible, history show us that geopolitical risks usually de-escalate with time.

Lessons from the supervision of climate risks

Bank supervisors have developed methodologies and practices to integrate climate risks into prudential frameworks. The advancements achieved in this area can provide a base for them as address geopolitical risks too. Our research shows that supervisors should focus on scenario analysis and governance requirements.

Supervisors have increasingly relied on diverse scenario analyses to test banks' resilience to climate risk. Developing geopolitical scenarios can help supervisors to identify which developments are most likely to impact the banking sector and financial markets. These might focus on specific sectoral macrofinancial impacts, such as energy security. In 2026, the ECB will conduct a thematic stress test on geopolitical risks. Methodological advancements in climate risk assessments can serve as a blueprint for supervisors to examine how geopolitical shocks and their transmission channels may influence banks' solvency and profitability.

The integration of climate risks into prudential frameworks has also focused on embedding these risks into bank governance structures, including through resilience-enhancing tools such as transition plans. This approach could be applied to geopolitical risks, requiring, for instance, a clear allocation of responsibilities across business, such as cross-functional points of contacts; a framework for identifying geopolitical risks from both a financial and non-financial perspective; and geopolitical considerations in the "fit and proper" assessments of senior management.

Future pathways for research and policy investigation

There are several areas where geopolitical risks may extend beyond the current state of the art in integrating climate risks into the risk management practices of banks.

Supervisors face multiple risks that have broad societal implications and amplify each other through feedback loops. This creates the risk of burdensome, multiplying yet siloed supervisory assessments and expectations. Compounding risks should be integrated into a single framework. The short-term climate scenarios from the Network for Greening the Financial System offer a practical example of how geopolitical considerations could be incorporated into climate scenario analysis. Designed in the aftermath of the Russian invasion of Ukraine these scenarios provide a structured approach to evaluating the near-term effects of climate transition pathways on financial stability and economic resilience, while explicitly accounting for energy-security implications.

Central banks and financial supervisors increasingly recognise that climate (and nature) risks are partially endogenous to the financial system: financial actors amplify the magnitude of such risks through their behaviours, incentives and market dynamics, creating feedback effects for individual institutions and the broader system ("double materiality"). While geopolitical risks are typically viewed as external shocks to the financial system ("exogenous" risks), future research could investigate their partial endogeneity – for instance through the engagement of banks with their strategies' sectoral or geographical dependencies (such as value chains that are dependent on rare-earth minerals).

The double materiality logic developed for climate risks could help better anticipate and even mitigate geopolitical vulnerabilities, including by encouraging or requiring institutions to develop preparedness plans or set limits to tackle geopolitical exposures. Some supervisors, including at the ECB, have already taken steps in this direction, asking banking institutions to scale down their presence in Russia due to compliance and financial risks.

Addressing these challenges requires an evidence-based understanding of geopolitical risks as drivers of prudential risk categories and their compounding links to climate risks. Since supervisors must manage these challenges amid declining multilateral co-operation, further research is needed to understand and inform supervisory practices globally and nationally. Amidst new uncertainties, working in siloes has become a risk that bank supervisors can no longer afford. Embracing integrated analysis and collaborative learning offers the most resilient path forward for safeguarding banks' stability.

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