IFRS S2 in Practice: Transition and Physical Risk for East African Lenders

Portfolio Heat-Mapping, Scenario Choices, and Data Proxies for Thin Datasets

For East African lenders, the introduction of the International Financial Reporting Standards (IFRS) S2 (Climate-related Disclosures) is a pivotal development, raising the bar on how climate risk is assessed, managed, and disclosed. Aligned with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), IFRS S2 requires lenders to move beyond simple environmental screening to disclose on governance, strategy, risk management, and metrics and targets related to climate-related risks and opportunities.

This article provides a practical guide for East African lenders—including commercial banks, private equity funds, and Development Finance Institutions (DFIs)—on implementing the most challenging strategic elements of IFRS S2: assessing **transition risk** and **physical risk** within their portfolios.

1. Assessing Climate Risk through Portfolio Heat-Mapping

A **portfolio heat-mapping** exercise is the essential first step for an East African lender to integrate IFRS S2 and TCFD into its risk management framework.

A. The Process

1. **Exposure Segmentation:** Categorize the lending portfolio by vulnerable sectors (e.g., Agribusiness, Energy, Real Estate, Manufacturing) and geographic locations (e.g., coastal areas, semi-arid regions).
2. **Risk Scoring:** Assign an inherent risk score for both physical and transition risks to each segment.
    - **Physical Risk:** High scores for assets highly dependent on consistent water supply (Agribusiness) or located in known flood/drought zones.
    - **Transition Risk:** High scores for borrowers in carbon-intensive sectors (e.g., heavy manufacturing, fossil fuels) facing policy shifts (e.g., carbon taxes, renewable energy mandates).
3. **Visualization:** Generate a heat map showing the highest concentration of risk by sector and geography, allowing for **portfolio or asset heatmapping for lenders**.

Outcome: A **transition and physical risk register** that informs capital allocation and engagement priorities.

2. Scenario Choices: NGFS-Aligned Analysis

IFRS S2 requires lenders to assess the resilience of their strategy to climate-related changes, which is best achieved through **scenario analysis**. Given the unique challenges in East Africa, using scenarios developed by the **Network for Greening the Financial System (NGFS)** is recommended.

Scenario Type	Focus and Relevance for East Africa	IFRS S2 Implication
Orderly Transition	Policy is introduced early and	Helps map **emissions**

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	gradually (e.g., slow carbon pricing, moderate clean energy mandates). Relevant for **transition risk** in sectors with long asset lifespans (e.g., Geothermal, Infrastructure).	**pathways** and *transition risks* to guide lending towards lower-carbon projects.
Disorderly Transition	Policy is sudden, late, or uncoordinated (e.g., abrupt ban on single-use plastics or coal). Relevant for borrowers reliant on export markets with strict carbon border adjustments.	Highlights the risk of **stranded assets** and potential *litigation and greenwashing risk* from non-compliant borrowers.
Hot House World	Assumes little or no climate action, leading to severe physical impacts (e.g., +3^{\circ} \mathrm{C} or more). **Most critical for East Africa**, which faces heightened exposure to drought, flooding, and sea-level rise.	Quantifies the impact of **physical risk** (e.g., asset damage, operational downtime, supply chain disruption) on loan collateral and borrower viability.

Action Point: Conduct **NGFS-aligned scenario analysis** to inform a board-approved climate policy.

3. Data Proxies for Thin Datasets

A significant challenge for East African lenders is the lack of granular, entity-level climate data from borrowers, especially SMEs or unlisted companies (the **"thin datasets"** problem).
To overcome this, lenders must rely on defensible data proxies:

Data Challenge	Recommended Data Proxy / Solution	Relevance
Borrower Emissions Data (Scope 1–3)	Use **sector-level emissions intensity factors** (e.g., tonnes \mathrm{CO}_2e per \$ \mathrm{M} in revenue) for the borrower's industry in the relevant jurisdiction.	Allows for initial *Scope 3 screening* and the setting of portfolio emissions pathways.
Specific Climate Hazard Exposure	Use **geospatial data** (e.g., flood maps, drought indices) at the catchment or region level to assess risk, rather than relying on borrower self-reporting.	Crucial for **asset heatmapping** and assessing physical risk to property or operations.
E&S Compliance Status	Conduct a **PE/DFI E&S Gap Assessment** (within 15 business days) or full **ESG Due Diligence (ESDD)** on material transactions.	Provides **clean diligence files** and compliance check against IFC PS/EP, which is a key indicator of climate governance.

Action Point: Develop a robust **data plan and controls** for the first reporting cycle, ensuring all assumptions are documented and auditable.

By methodically addressing heat-mapping, scenario analysis, and data limitations, East African lenders can move from climate intention to investor-grade disclosures, securing DFI facilities and improving investor relations.