ESG risks management in banking sector

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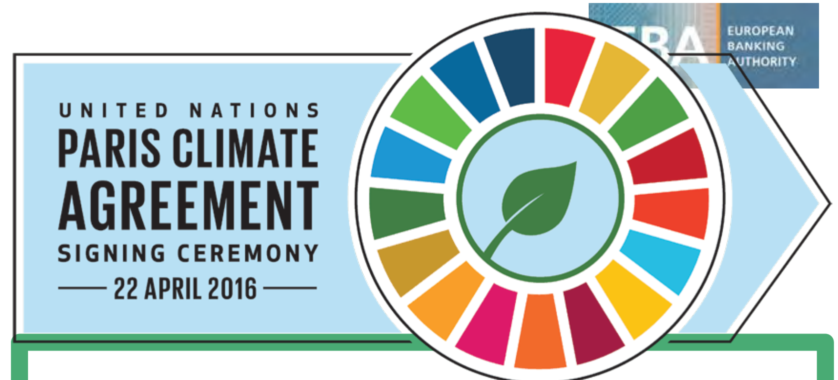
Where are we coming from?



Global temperature: Holding temperature to well below 2°C above pre-industrial levels and efforts to limit the temperature increase to 1.5°C

Adaptation: Increasing the ability to adapt to the adverse impacts of climate change

Finance flows consistent with the objectives

EU Action plan

One comprehensive strategy | Three main objectives | Ten Actions

1. **Reorienting capital flows** towards sustainable investment
2. **Mainstreaming Sustainability into risk Management**
3. **Fostering transparency** and **Long-termism**

European Green Deal

European Commission leading on sustainable finance

2018 – Action plan Financing Sustainable Growth → **2020 – Consultation on Renewed Sustainable Finance Strategy**

Actions	
EU classification (taxonomy) for sustainable activities	Reliable Information
Standards and labels for 'green' financial products give investors certainty	
Study if capital requirements should reflect exposure to climate change and environmental risks	Sustainability and Risk Management
Clarify institutional investor duties to consider sustainable finance when allocating assets	
Enhancing non-financial information disclosure	Long-Termism in Governance

EBA mandates on sustainable finance

EBA REGULATION

Monitoring system to assess material ESG risks

Consider ESG factors in EBA work

SUSTAINABILITY DISCLOSURE REGULATION

ESAs RTS on sustainability on
(i) pre-contractual disclosure;
(ii) websites content;
(iii) periodical reports;
(iv) presentation of information on sustainable finance

EC ACTION PLAN

Contribution to TEG work
- Taxonomy
- Green bonds standard
- Guidelines on climate disclosure
- Benchmarks

Action 10 Call for advice on undue short-term pressure

Platform on sustainable finance

CRR AND IFR

Disclosure of ESG-related risks, physical and transition risks

Assessment of prudential treatment for exposures associated with environmental and/or social objectives

CRD AND IFD

Potential inclusion of ESG risks in risk management and SREP
- Definitions
- Stress testing processes
- ESG risks assessment
- Impact of ESG risks on lending

EBA EUROPEAN BANKING AUTHORITY

Strategy and risk management

↓

Key metrics and disclosure

↓

Scenario analysis and stress testing

↓

Prudential treatment

Additional mandates in 2020:
- Call for advice on Article 8
- Report on sustainable securitisation
- RTS on sustainability indicators for securitisation disclosure

Why is this relevant for banking sector?

Green path

Global agreement implemented

New standards and restrictions
Adaptation projects

Impact on businesses and citizens

Impact on financing banks and financial system

re-pricing,
stranded assets,
litigations

Red path

Global warming continues

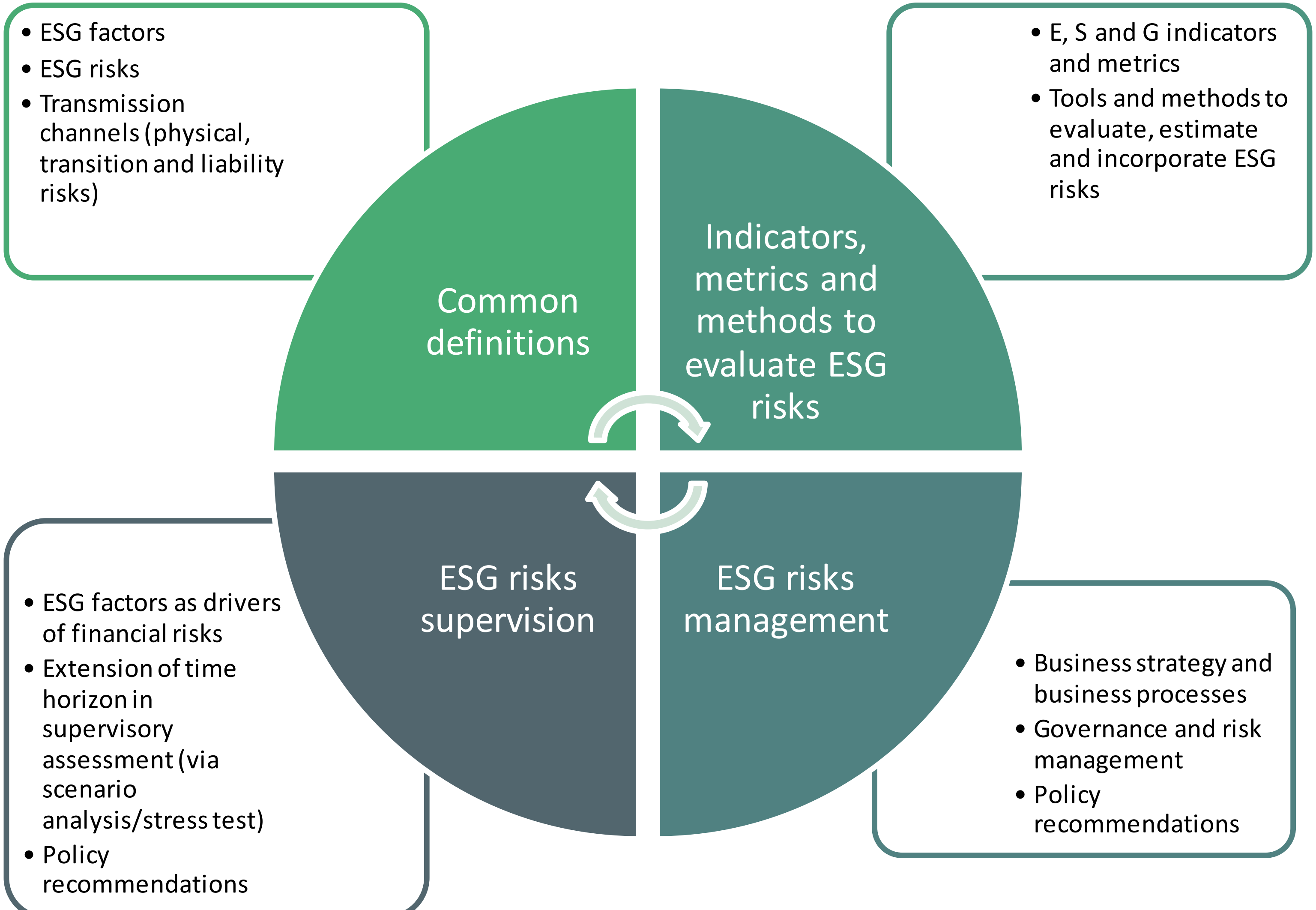
Irreversible climate changes with consequences

Impact on businesses and citizens

Impact on financing banks and financial system

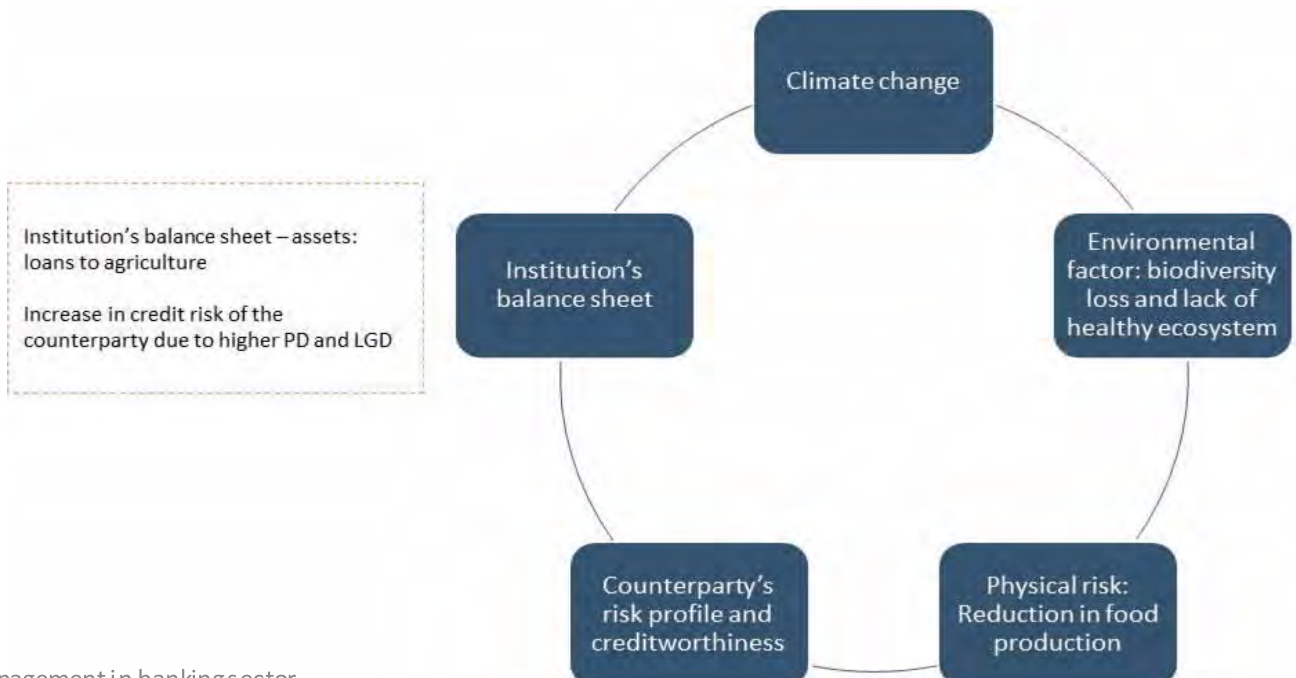
re-pricing,
increased risks from physical events

Discussion paper on ESG risks management and supervision

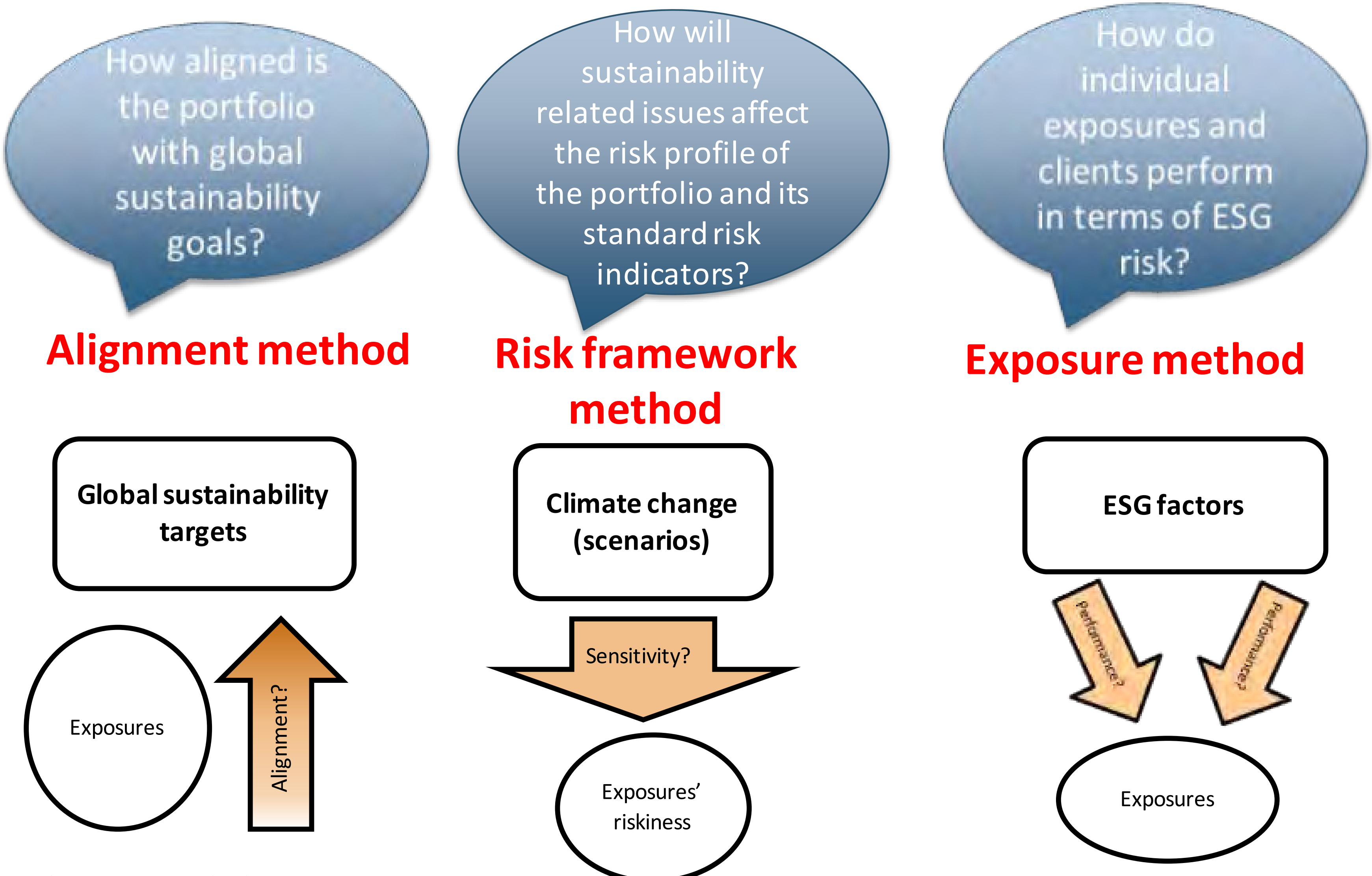


Common definitions and transmission channels

- ESG factors are environmental, social or governance characteristics that may have a positive or negative impact on the financial performance or solvency of an entity, sovereign or individual.
- Focus of the report: While institutions are directly exposed to ESG factors, ESG risks materialise when ESG factors affecting institutions' counterparties have an impact on the financial performance or solvency of institutions.



Methodological approaches



ESG risks management

Current status of of integrating ESG risks into business strategies, risk management and governance (incl. recognition of challenges)

Three main areas where ESG should be incorporated:

- Business strategies and business processes
- Governance arrangements
- Risk management process, including stress testing

These elements are seen as part of a proactive risk management approach

- Monitoring of business environment - long-term resilience
- Setting strategic ESG risk objectives and limits
- Customers engagement
- Considering sustainable products

Scope of ESG disclosures

Scope of disclosures

Pillar 3 ITS

Governance

Qualitative information on responsibilities of the management body, governance arrangements, lines and frequency of reporting, remuneration policy

Business model and strategy

Information on adjustment to business strategies to mitigate and reduce environmentally harmful activities and promote environmentally sustainable activities; Engagement with customers

Volume of investment (current and targets) in sustainable economy and in EU Taxonomy aligned activities ***(GAR)***

To be disclosed also under Article 8 of Taxonomy Regulation

Risks

Exposures towards carbon related sectors, including information on credit quality

Exposures towards sectors and geographies subject to the impact of climate change extreme events

Risk management

Information on processes to identify/monitor risk sensitive sectors and exposures; Limits, controls and Forward looking information; stress test and scenario analysis

Risk mitigation actions

Exposures towards taxonomy aligned activities contributing to or enabling climate change or climate change adaptation: ***(GAR)***

Other mitigating actions, including exposures mitigating climate change do not meet the criteria to be taxonomy aligned

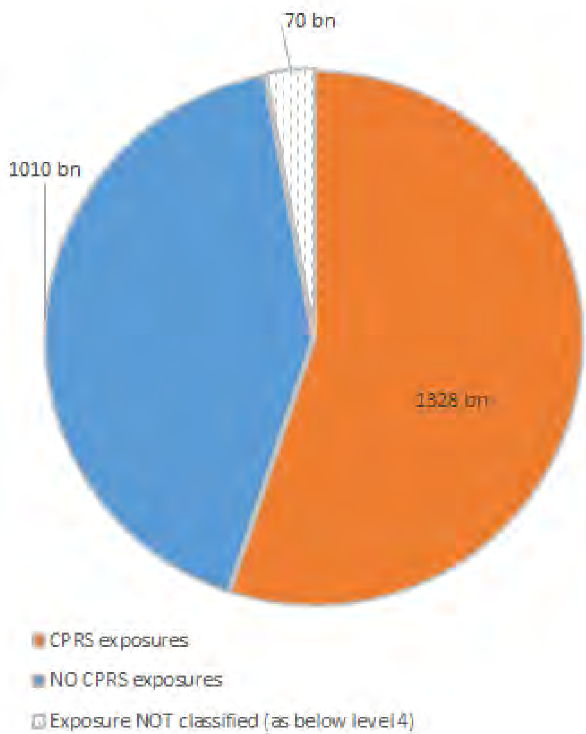
EBA pilot climate sensitivity analysis exercise

- In 2020 the EBA launched a pilot sensitivity exercise on climate risk with a sample of 29 volunteer banks
- Focus on on transition risk, and its main objectives are
  - ✓ (i) to explore data and methodological challenges related to climate risk assessment;
  - ✓ (ii) to test banks' readiness to apply the EU green taxonomy for classifying their own exposures; and
  - ✓ (iii) to provide a preliminary comparable assessment on banks exposures in respect to climate risk, based on different data classifications
- The total original exposure submitted by banks amounts to EUR 2.4 trillion (42% of total corporate exposure and 78% of non-SME corporate exposures in EU countries)

CPRS analysis: Preliminary results at EU level (1/2)

At EU level, out of EUR 2.4trn of banks exposure, EUR 1.3trn (55% of the total) resulted to be allocated towards climate policy relevant sectors

CPRS breakdown of total exposures (EUR bn)



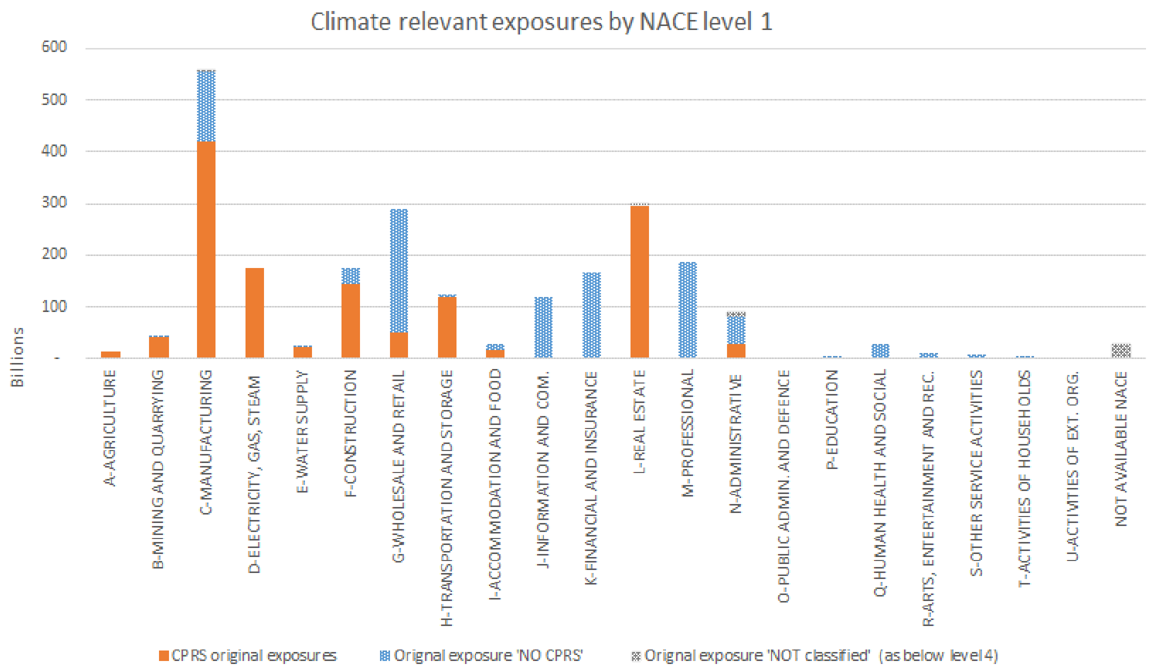
- **Climate policy relevance (CPRS)**: indicates the potential vulnerability of a sector to transition risk (applied by ECB and EIOPA).
- CPRS is defined based on the sector greenhouse gas emissions, its role in the energy supply chain and the carbon leakage risk classification (which affects those sectors for which either costs or competitiveness is heavily affected by introduction of a carbon price).

Battiston et al., 2017. "A climate stress-test of the financial system", Nature Climate Change 7, 283-288.

CPRS analysis: Preliminary results at EU level (2/2)

- Climate relevant exposure concentrated in Manufacturing (C), Electricity (D), Construction (F), Transportation (H) and Real Estate (L) for a total amount of EUR 1,153bn.

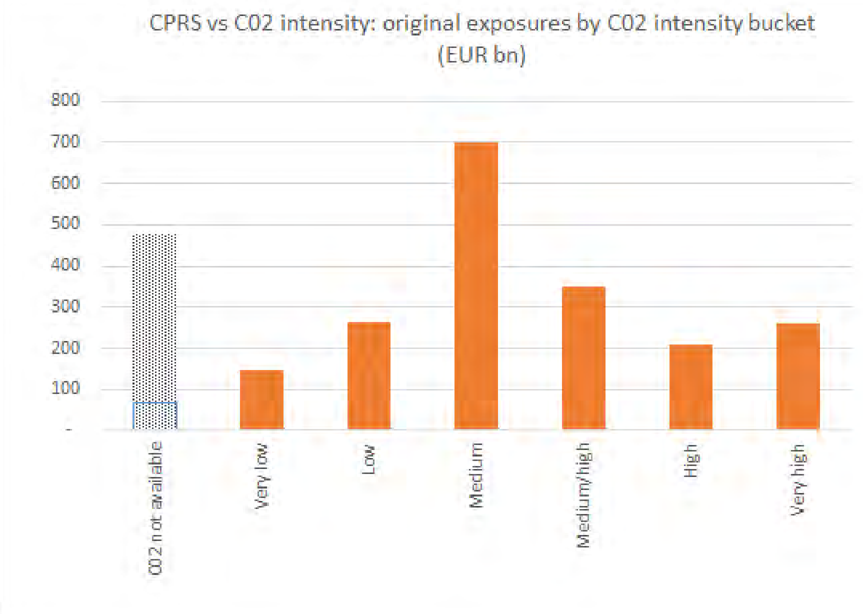
- Exposures towards other NACE2 level 1 sectors, such as Mining (B), and Whole or Retail Sale (G), which incorporate climate relevant sub sectors, are less significant.



- Exposures towards financials holdings amount to EUR 167bn and are classified as ‘no CPRS’. More detailed information on the related activity would be needed to run a more accurate assessment (especially for holdings).

C02 emission analysis : EU Exposures by C02 intensity range

- Only 30% of the total exposures under scope is matched directly with individual GHG data while 60% of the exposures are assigned to obligors by using average GHG emission intensity at NACE2 level 4.



C02 intensity (X-axis)	
Label	Range
Very low	C02 ≤ P10
Low	Q1 ≥ C02 > P10
Medium	Median ≥ C02 > Q1
Medium/high	Q3 ≥ C02 > Median
High	P90 ≥ C02 > Q3
Very high	C02 > P90

- Almost EUR 816bn of original exposures are towards obligors with medium/high, high or very high C02 emission intensity.

EBA deliverables in 2021-2022

Q1-Q2 2021

- Outcome of phase 2 of **Pilot sensitivity analysis** - Q1 2021
- Final **Report on ESG risk management and supervision** – June 2021
- ESAs updated RTS on taxonomy-related product disclosures – June 2021

Q3-Q4 2021

- Final **ITS on ESG disclosures in Pillar 3** – Q3 2021
- **Report on sustainable securitisation framework** - November 2021
- **Discussion paper on prudential treatment of assets** linked with sustainability objectives – end of 2021

2022 - 23

- **Guidelines on ESG risk management for institutions** and integration of **ESG risks in SREP Guidelines**
- Integration of climate scenario analysis in the EBA risk analysis work
- Extension of disclosure requirements (sequential approach)

Relevant EU initiatives in 2021

EU Taxonomy and transition finance	Disclosures under Taxonomy Regulation	Review of NFRD
ESAP – European single access point	EU Green Bond Standard	Renewed SF strategy

Global initiatives

- **Network for Greening the Financial System (NGFS)**: voluntary coalition of 83 central banks or supervisors to mainstream climate risk management and green finance:
  - WS *Microprudential/Supervision*: Guide on integrating climate-related and environmental risks into micro-prudential supervision; Assess financial risk differentials between green/non-green; Review existing measurement methodologies
  - WS *Macrofinancial* (develop climate scenarios and guide macroeconomic climate risk analysis), WS *Scaling-up green finance* (monitor market dynamics and central banks initiatives), WS *Data gaps* (identify available and needed data)
- **BCBS** – Task Force on Climate Risks: stock-take of practices and analytical reports on transmission channels and risk measurement methodologies
- **FSB** – pioneer disclosures initiative (2017, Task force on Climate-related Financial Disclosures). On-going work on implications of climate risks for financial stability.
- **IFRS foundation** – currently considering the establishment of a new Sustainability Standards Board to oversee a new harmonised reporting framework

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