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
European Commission leading on sustainable finance

2018 – Action plan Financing Sustainable Growth

- EU classification (taxonomy) for sustainable activities
- Standards and labels for ‘green’ financial products give investors certainty
- Study if capital requirements should reflect exposure to climate change and environmental risks
- Clarify institutional investor duties to consider sustainable finance when allocating assets
- Enhancing non-financial information disclosure

2020 – Consultation on Renewed Sustainable Finance Strategy

- Reliable Information
- Sustainability and Risk Management
- Long-Termism in Governance

ESG risks management in banking sector
EBA mandates on sustainable finance

**EBA REGULATION**
- Monitoring system to assess material ESG risks
- Consider ESG factors in EBA work

**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

**SUSTAINABILITY DISCLOSURE REGULATION**
- ESAs RTS on sustainability on
  1. Pre-contractual disclosure;
  2. Websites content;
  3. Periodical reports;
  4. Presentation of information on sustainable finance

**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

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

ESG risks management in banking sector
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

ESG risks management in banking sector
Discussion paper on ESG risks management and supervision

- ESG factors
- ESG risks
- Transmission channels (physical, transition and liability risks)

Common definitions

- ESG risks supervision
- ESG risks management

Indicators, metrics and methods to evaluate ESG risks

- E, S and G indicators and metrics
- Tools and methods to evaluate, estimate and incorporate ESG risks

ESG factors as drivers of financial risks
- Extension of time horizon in supervisory assessment (via scenario analysis/stress test)
- Policy recommendations

Business strategy and business processes
- Governance and risk management
- Policy recommendations
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.

![Diagram]

- **Institution’s balance sheet** – assets: loans to agriculture
- Increase in credit risk of the counterparty due to higher PD and LGD

**Climate change**

**Institution’s balance sheet**

**Environmental factor: biodiversity loss and lack of healthy ecosystem**

**Counterparty’s risk profile and creditworthiness**

**Physical risk: Reduction in food production**
Methodological approaches

Alignment method

- How aligned is the portfolio with global sustainability goals?

Risk framework method

- How will sustainability related issues affect the risk profile of the portfolio and its standard risk indicators?

- Climate change (scenarios)
  - Sensitivity?
  - Exposures’ riskiness

Exposure method

- How do individual exposures and clients perform in terms of ESG risk?

- ESG factors
  - Performance?

Global sustainability targets

Exposures

Exposures

ESG risks management in banking sector
Current status 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

<table>
<thead>
<tr>
<th>Scope of disclosures</th>
<th>Governance</th>
<th>Pillar 3 ITS</th>
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<tbody>
<tr>
<td>Governance</td>
<td>Qualitative information on responsibilities of the management body, governance arrangements, lines and frequency of reporting, remuneration policy</td>
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<tr>
<td>Business model and strategy</td>
<td>Information on adjustment to business strategies to mitigate and reduce environmentally harmful activities and promote environmentally sustainable activities; Engagement with customers</td>
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<td></td>
<td>Volume of investment (current and targets) in sustainable economy and in EU Taxonomy aligned activities <em>(GAR)</em></td>
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<td>Risks</td>
<td>Exposures towards carbon related sectors, including information on credit quality</td>
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<td>Exposures towards sectors and geographies subject to the impact of climate change extreme events</td>
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<tr>
<td>Risk management</td>
<td>Information on processes to identify/monitor risk sensitive sectors and exposures; Limits, controls and forward looking information; stress test and scenario analysis</td>
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<td></td>
<td>Risk mitigation actions: Exposures towards taxonomy aligned activities contributing to or enabling climate change or climate change adaptation: <em>(GAR)</em></td>
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<td>Other mitigating actions, including exposures mitigating climate change do not meet the criteria to be taxonomy aligned</td>
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To be disclosed also under Article 8 of Taxonomy Regulation
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 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

- **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).

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.

- 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


- **IFRS foundation** – currently considering the establishment of a new Sustainability Standards Board to oversee a new harmonised reporting framework