International Association of Credit Portfolio Managers

IACPM Research: ESG/Climate Risk Series

ESG & Climate Risk Management Frameworks

Significant Progress

ESG & climate risks are becoming a core component of risk assessment, risk measurement and risk management considerations within financial institutions. CPM must continue to adapt approaches to confront the new challenges and seize the developing opportunities in the industry.

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Introduction

ESG & climate risks are affecting various risk types, including market, reputational and credit risks, and are becoming a core component of risk assessment, risk measurement and risk management considerations within financial institutions. As such, firms are exploring risk management frameworks that are both actionable and able to assess these emerging risks qualitatively as well as quantitatively.

Against this backdrop, the International Association of Credit Portfolio Managers (IACPM) conducted the first in a planned series of ESG & climate risk surveys. This Survey focused on the integration of ESG & climate risk factors into credit risk management frameworks.

The Survey was conducted in Spring 2022, after two years of the COVID pandemic and the newly evolving geopolitical tension caused by Russia's invasion of Ukraine with its implications for climate agendas. Fifty-two IACPM member firms worldwide provided responses and insights. The survey results reflect a wide range of industry players globally, including banks, development banks, asset managers, and insurers.

Note on Survey demographics:

Over 50 financial institutions globally participated in this study, including 42 banks, five development banks, three asset managers, one insurer and one reinsurer. Some 50% of the participating firms have a total balance sheet size above US$ 500 Billion. In addition, IACPM staff conducted informal interviews with a number of participating firms to help inform observations.

> ***"The specific characteristics of environmental risks and their direct and indirect consequences, including in particular their multidimensional, non-linear, uncertain and forward-looking nature, could lead to an underestimation of these risks, a phenomenon that will likely accelerate over time."***
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> The Role of Environmental Risks in the Prudential Framework, Discussion Paper, EBA/DP/2022/02, 2 May 2022

Executive Summary

Approaches for the integration of ESG & climate risks into risk management processes depend largely on the nature, size, and region of a firm, but are also influenced by the type of assets held in the portfolio and existing organizational structures. There is no "one-size fits all" and firms are continuing to apply significant resources to develop and adapt as appropriate to meet new challenges and opportunities confronting the industry.

Ahead of expected regulatory disclosure requirements, all participating firms are planning to voluntarily publish at least some level of TCFD disclosures, and almost half had already done so by the end of 2021. In addition, many IACPM member firms, notably all larger banks, are already committed to Net-Zero targets.

Responsibility or at least co-responsibility for the integration of environmental (including climate), social, and governance (ESG) risks into Credit Risk Management Frameworks often lies with the CRO/Risk office. A range of approaches to integrate climate risk considerations into Credit Risk Management Frameworks can be observed of which all require enterprise-wide collaboration and linkages.

Climate risk management frameworks for large corporates, fixed income investments, project and infrastructure finance are still better developed than for other areas within participating firms.

Three-quarters of all participating firms already established a Head of Sustainability/ESG and close to that number have also established dedicated Sustainability Teams at the Group level.

Industry players across sectors and regions recognize the significance of ESG & climate risk factors for credit portfolios and are accelerating efforts to adjust internal risk management processes, including concentration risk frameworks. Planned headcount increases, which are largest at CRO/Risk offices and the Line of Business, are a reflection of the existing momentum. At large firms, planned headcounts can exceed 100 FTEs for business, risk, and sustainability teams combined.

At three-quarters of participating firms, Credit/Deal committees, Sustainability committees and Reputation committees consider climate transition as well as climate physical risks, at least qualitatively but also quantitatively (up to 15%), in their decision making.

ESG & climate risk considerations are being embedded into all functions, including Credit Portfolio Management (CPM). At least half of the participating firms are already considering ESG & climate risks in CPM decision making, notably for concentration management. Much of the current CPM functions' focus is directed toward ESG and emissions reporting, identification of climate physical risks, and advising on metrics and tolerances for enterprise risk appetite as well as tracking portfolio progress in climate transition.

The absence of reliable data and comparable methodologies along with the currently fragmented regulatory and reporting landscapes are proving to be challenging for all industry players. Retail, SMEs and securitization in particular are lacking available data which combined with missing borrower awareness in these asset classes will, for now, keep the industry looking for proxy solutions.

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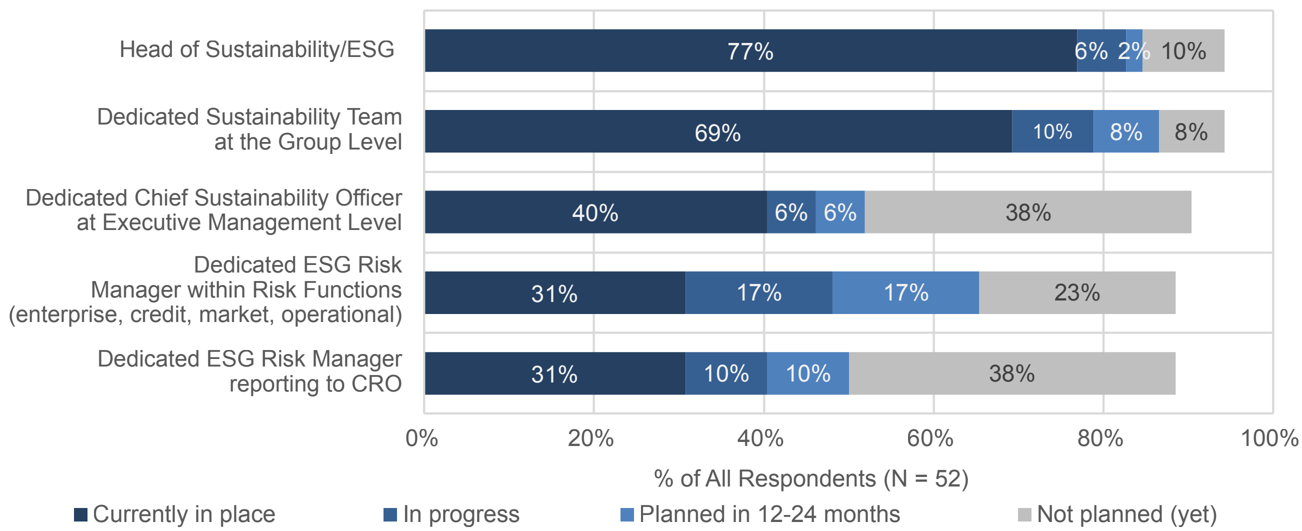
Organizational Structure & Governance

Three-quarters of all firms participating in the Survey have already established a Head of Sustainability/ESG and close to that number have also established dedicated Sustainability Teams at the Group level. Over half of the responding firms have or are planning to establish a C-level position of Chief Sustainability Officer.

There are regional differences. For EMEA, all larger firms and a majority of smaller firms are reporting established **Heads of Sustainability/ESG** along with **dedicated Sustainability Teams at the Group Level**. The percentage of firms in the Americas and APAC with established functions are slightly lower.

In contrast, **dedicated Chief Sustainability Officers (CSO)** can be found at almost 60% of all larger firms in the Americas, but only at about one-third of firms in EMEA, regardless of size.

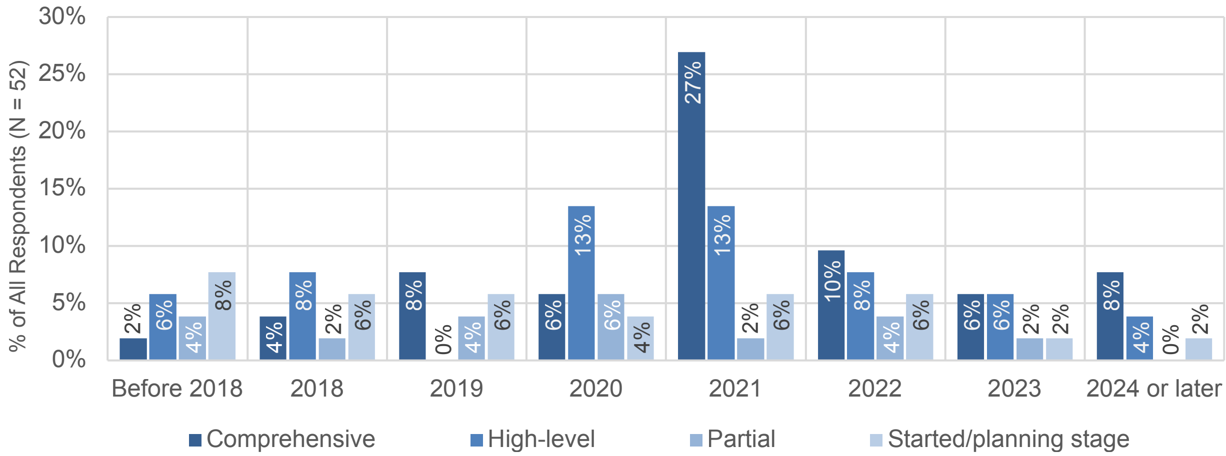
Figure 1:
ESG & Climate Risk governance frameworks currently in place or planned



All participating firms are planning to publish TCFD disclosures, and almost half had already done so by the time this survey was conducted. Over a quarter of survey participants published a comprehensive disclosure for the first time last year (2021) and another quarter are planning to do so soon.

A quarter of firms with Net Zero Commitments or planned Net Zero Commitments are not expecting to issue a comprehensive TCFD disclosure. Many of those firms are publishing disclosures through other reports, such as integrated annual reports, responsible investment reports, or the Universal Registration Document. In contrast, almost half of firms with no Net Zero commitments are also not expecting to issue comprehensive TCFD or other disclosures. Note: In the EU, TCFD is implemented through NFRD/CSRD (with double materiality), mandatory as of the end of 2022, as well as through the 2021 banking package published in October 2021.

Figure 2:
TCFD disclosure progress: First year of publishing

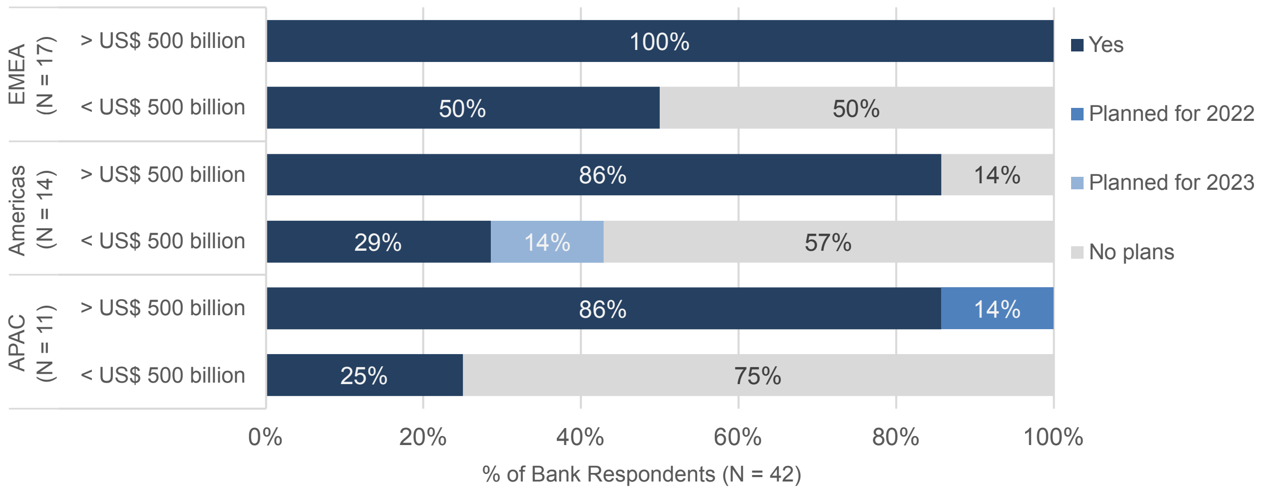


Almost all participating banks with total balance sheets assets greater than US$ 500 bn are already committed (92%) or are planning to commit to Net Zero over the next 18 months (4%). About half of all survey participants are members of the Glasgow Financial Alliance(s) for Net-Zero [1].

Some 90% of banks with no Net Zero commitment plans have less than US$ 500 billion in total balance sheet assets; and 70% have less than US$ 250 billion. For many of those banks this is work in progress while they are studying various methodologies and transition approaches for an informed decision in the future.

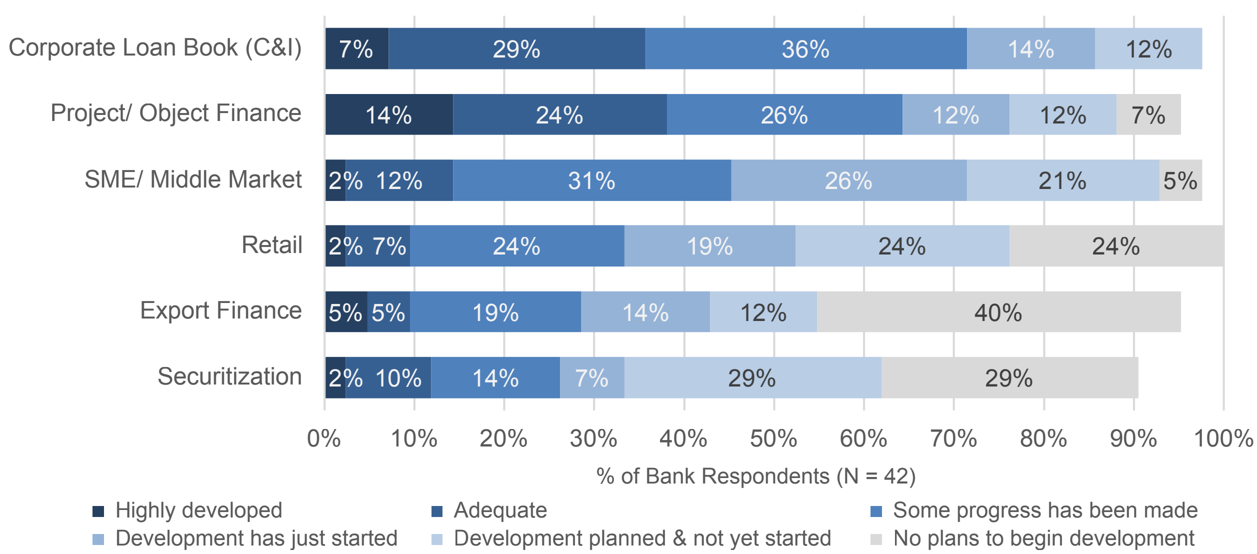
Big banks are seemingly driving Net Zero commitments in the industry, but challenges to meet Net Zero targets remain, including the well documented absence of standardized, reliable, and comparable methodologies to estimate GHG emissions. The convergence of interests across geographies and industries, banks, and investors, allows firms to work together to alleviate identified obstacles.

Figure 3:
Net Zero Commitment/ target



Climate risk management frameworks are better developed for the corporate loan book as well as project and infrastructure finance than for other areas within firms. Large exposure amounts and public attention might drive the more dominant profiles for these asset classes. Mainly for development banks, export finance plays an important role. Integrating climate risk considerations into credit risk management frameworks for SME, retail and securitization (i.e., investments in securitizations issued by third parties) will most likely present more challenges due to lack of data availability, borrower awareness or capacity to adapt.

Figure 4:
Firms' level of development integrating Climate Risk considerations into credit risk management frameworks

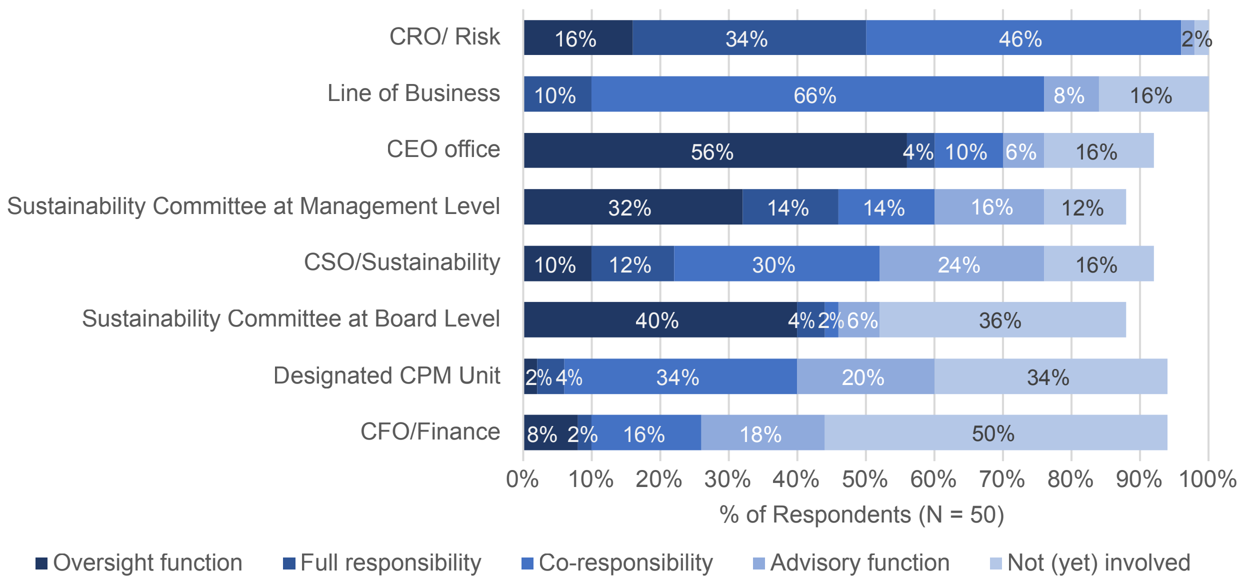


Roles & Responsibilities

At almost all participating firms the CRO/Risk office has at least co-responsibility for the integration of Environmental, Social and Governance risks into Credit Risk Management Frameworks. Responsibilities might shift to other areas as ESG risks, including biodiversity and other nature-related risks, are better understood and become more integrated into existing processes.

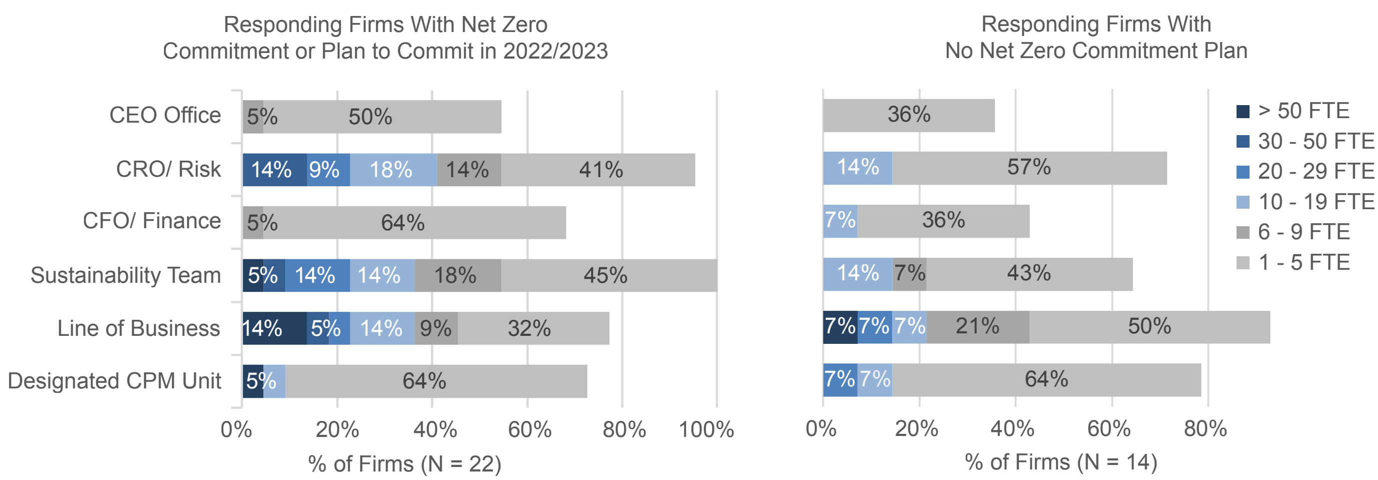
The range of observed approaches for integrating Climate Risk considerations into Credit Risk Management Frameworks all require linkages across the firm. One example starts with the creation of an ESG & Climate Risk Center of Competence with the goal of increasing awareness of ESG & Climate Risk across all functions and ultimately embedding sustainability into the firm's risk culture & DNA.

Figure 5:
Areas currently involved and/or responsible for integrating Climate Risk considerations into credit risk management frameworks



Planned headcount increases to support climate risk integration are greatest at CRO/Risk offices and Line of Business, and noticeably higher at participating firms that are either already committed to Net Zero or are planning to commit over the next 18 months. At the largest firms, combined headcounts can exceed 100 FTEs for business, risk, and sustainability teams.

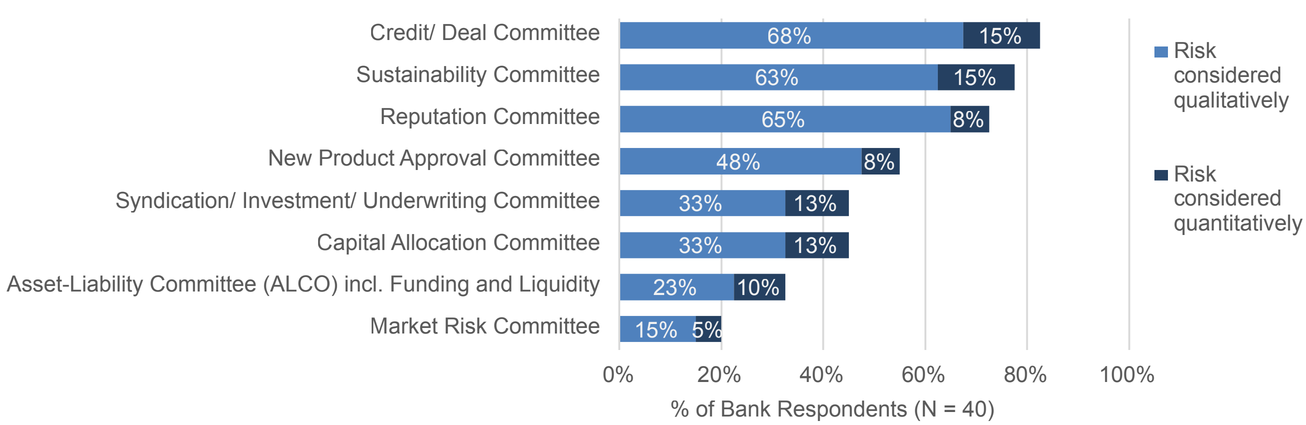
Figure 6:
Estimated headcount (FTE) planned in 12-24 months for areas involved and/or responsible for integrating Climate Risk considerations into credit risk management frameworks



Credit/Deal Committees, Sustainability Committees as well as Reputation Committees at three-quarters of participating firms consider Climate Transition and Physical Risks qualitatively and some also (up to 15%) quantitatively in their decision making. New Product Approval Committees and Capital Allocation Committees are both starting to consider climate risks.

Market Risk Committees are expected to increase Climate Transition and Physical Risk considerations once either carbon markets are more mature and financed emissions for derivatives can be calculated, and/or sustainable companies are receiving higher value premiums.

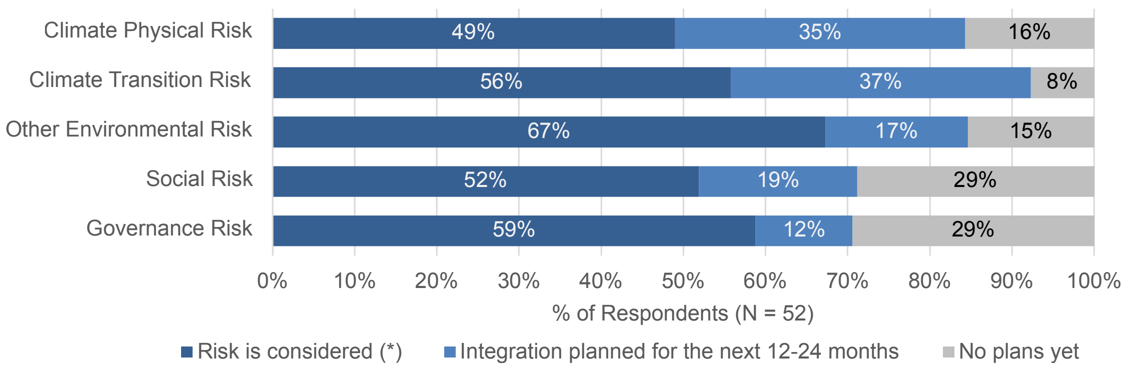
Figure 7:
Committees that are currently considering Climate Transition Risk factors in their decision making



Role of Credit Portfolio Management

At least half of the participants are considering ESG & climate risks in CPM decision making, including concentration management, often qualitatively and mainly for larger exposures and/or for select asset classes. Improvements have already been identified to integrate the risks in more detail into credit assessment and lending or investment decision-making processes, using climate heatmaps, internal and external data as well as ESG scores. Primarily firms in the Americas cite ESG reputational risks as an additional risk to consider.

Figure 8:
ESG & Climate Risk factors consideration in CPM decision making, e.g., to manage concentrations

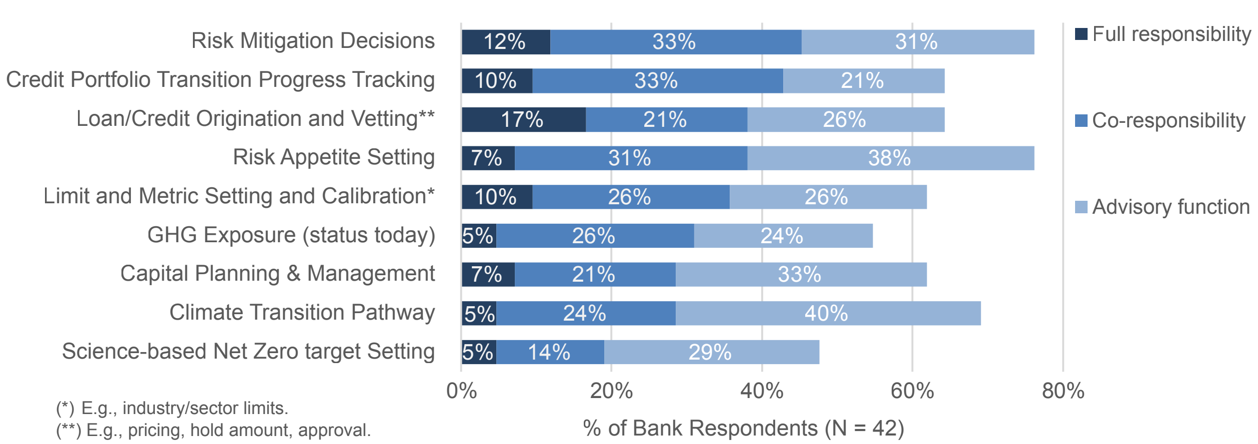


ESG is being embedded into all functions, including CPM. Much of the current CPM function focus is directed toward ESG and emissions reporting, identification of concentrations in climate physical risks, tracking portfolio progress in climate transition, and advising on metrics and tolerances for enterprise risk appetite.

At firms that are committed or planning to commit to Net Zero, CPM functions are more likely to also be responsible for including climate risk consideration in Capital Planning & Management than at firms that have no plans to set Net Zero targets.

CPM functions are often covered by various areas within firms. In addition to CPM, those areas can include Enterprise Risk Management, Lines of business, Portfolio Analytics, and Group Sustainability.

Figure 9:
CPM functions' level of involvement in Climate Risk considerations



(*) E.g., industry/sector limits.
(**) E.g., pricing, hold amount, approval.

Challenges and Path Forward

It is clear from the Survey responses that firms are taking significant steps to address ESG and Climate requirements, but many challenges remain. The absence of reliable data and comparable methodologies along with the currently fragmented regulatory and reporting landscape - which might lead to multi-level disclosure requirements - can require internal resource re-allocation, possibly away from initiatives to develop robust internal risk management processes or necessary to meet Net Zero targets.

In addition, integrating climate risk considerations into credit risk management frameworks for retail, SMEs and securitization will most likely present more challenges due to lack of data availability, but also borrower awareness or capacity to adapt.

All industry players, including banks, development banks, asset managers, and regulators, across all geographies, must work together to address these obstacles and also take advantage of new and developing opportunities.

There is no "one-size fits all" approach and CPM must continue to adapt as appropriate to confront the new challenges and seize new opportunities in the industry.

Demographics

Figure 10

Participating Firms' Total Balance Sheet Assets (N = 52)

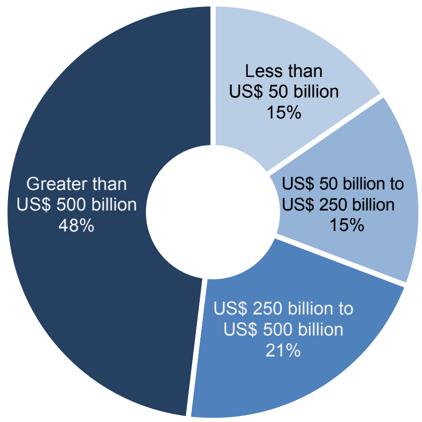
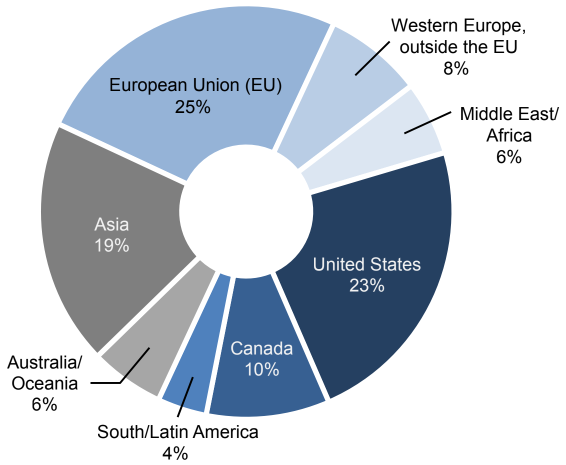


Figure 11

Participating Firms' Region of Domicile (N = 52)



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About the IACPM

The Association represents its members before regulators around the world, holds bi-annual conferences and regional meetings, conducts research on the credit portfolio management field, and works with other organizations on issues of mutual interest relating to the measurement and management of portfolio risk.

There are over 135 financial institutions worldwide that are members of the IACPM. These institutions are based in 28 countries and include many of the world's largest commercial wholesale banks, investment banks and insurance companies, as well as a number of asset managers.

Today credit market conditions, and new regulations, are shaping the financial services industry. The discipline of credit portfolio management is evolving within firms to include the measurement and management of credit risk at the enterprise level, in addition to execution of risk mitigation strategies in credit markets.

CPM has increasing linkages with: front-end credit originators; the setting of risk appetite and limit structures; funding and liquidity for the firm; and management of counterparty risk. CPM is also expanding coverage of credit assets beyond investment grade and leveraged to include middle market and retail, as well as in some cases bonds and other credit-sensitive instruments.

The IACPM recognizes the unique and evolving role of credit portfolio managers in today's financial environment, and offers an excellent forum through which these issues can be identified, understood and addressed.