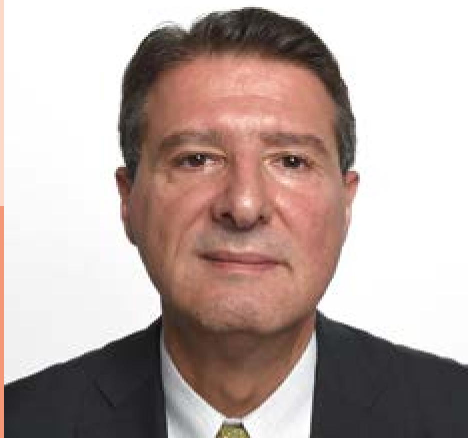
SUSTAINABILITY RISKS IN THE BANKING SECTOR



FRANÇOIS HAAS
Deputy Director General, Financial Stability & Deputy Secretary General - Autorité de Contrôle Prudentiel et de Résolution (ACPR)

Sustainability risks: new tools to enhance the framework and reach our goals

Global pressure for transition is increasing. The COP28 has recognized the need for strong cuts in greenhouse gas emissions and transitioning away from fossil fuels in this critical decade to meet +1.5°C pathways. It also emphasized banks' role to improve the assessment and management of climate-related financial risks.

2023 witnessed extreme climate events and has been confirmed as the world's hottest year on record. Environmental-related factors, notably climate change, can affect all financial risks a bank is exposed to: credit, market, operational, reputational/legal. Banks' activities also impact the financial system and the economy, should they worsen environmental risks by failing to align with legally-imposed pathways. In order to improve the assessment and management of climate-related financial risks, banks and authorities should account for both financial and impact materialities in a systematic manner.

On this front, the EU is taking the lead by closing risk measurement gaps. The recent EBA report on the Pillar 1 treatment of ESG risks acknowledges current data limitations by recommending that banks integrate shortly these risks in their internal models through the use of expert judgment, as well as in collateral valuation, while swiftly building the relevant datasets. Moreover, to overcome these challenges in the medium term, the EBA will consider how scenario analysis could be used to enhance the forward-looking elements of the prudential toolset. Climate stress-testing will certainly help a lot for this; on the Commission's request, the EBA is developing a framework to make it a regular exercise.

Regarding transition risks measurement specifically, two streams of work strongly contribute to bridging the gaps. The first one relates to the identification, collection and methodology to analyse granular information on debtors' climate footprint and transition pathways, such as Banque de France's Climate Indicator initiative, which will expand to more sectors in 2024 to fulfil banks and authorities' needs. The second one is the Fit-for-55 exercise which will allow to assess the ability of banks to face the decarbonization of the economy by 2030. Of course, these public-led efforts should not avail banks from deepening their knowledge of financed emissions and adapt their risk management and activities via transition planning.

While measurement keeps improving, the EU is keen on developing prudential treatments and responses to ESG risks. Leveraging on the current supervisory framework, the ECB-SSM is taking firm actions following the outcome of its thematic review that has shown EU banks are lagging behind full compliance with supervisory expectations on the integration of environmental risks in governance and risk management. ACPR has led a similar exercise and will finalise the ensuing recommendations early this year.

Supervisors will also gain new tools through the new banking package that will enter into application in 2025. CRD6 introduces risk-based transition plans; EBA guidelines will specify their content and translation into Pillar 2 requirements as part of a holistic assessment of a banks' climate-related financial risks. The supervisor will be able to step forward to ensure the effective implementation of these plans and adjust targets and actions in case of inadequate risk management. It will be crucial to ensure consistency with other transition plans and disclosures, such as those required by CSRD and CSDDD.

Apart from supervision, CRD6 will open new regulatory fields of work, with Pillar 1 mandates that will deliver conclusions by end 2025 on the effective riskiness of exposures impacted by environmental factors and a potential dedicated prudential treatment. In this process, authorities will keep in mind the need to facilitate transition financing without altering the risk-based nature of regulation nor giving way to greenwashing, e.g. in designing sectoral supporting factors or green loan guidance.

EU advances on ESG risk will be all the more beneficial if all jurisdictions share such effort.

Multilateralism has allowed to promote a common understanding of climate risks. The NGFS work on scenarios and data gaps helps supervisors to build capacity and identify priorities. In the next two years, it will focus on implementation; its reports on transition planning will feed into the work of standard-setters to foster global adoption. The Basel Committee's broad approach in exploring climate resilience, scenario analysis and regulatory treatment progresses; it reached a major milestone with the recently publication of a proposal for Pillar 3 disclosure of climate-related financial risks. Finally, to address a current, nearly blind spot, NGFS has put together a much needed conceptual framework for nature-related financial risks.

All these regulatory efforts are vital, as environmental risks could fuel the next major global financial crisis; taking into account jurisdictional constraints should not prevent us from acting.

JOSÉ MANUEL CAMPA
Chairperson - European Banking Authority (EBA)

Embedding ESG risk for an effective transitioning effort

Climate and overall ESG risks are here to stay, evolve, and potentially increase due to compounding effects. These risks are not new, but they have become more acute and chronic, impacting corporations' global value chains and transforming many business environments.

Predicting precisely how these changes will occur, and the implications for financial risk is challenging – this is why we need scenarios to help distinguish where the impacts and underlying risks may further develop from their current state. It's akin to predicting how brown syrup will spread within clear water over time, knowing it will not evaporate.

Risk management efforts by banks to handle ESG risks appropriately are crucial: their materialisation is already observable, and their future changes are uncertain generating various risk levels and types to consider simultaneously across different horizons.

The syrup analogy is apt: it changes the colour of the water, its density, its availability, its drinkability, and at different rates. Similarly, this dark syrup impacts the already identified risks to the water while potentially adding new ones. For the same reasons, environmental and ESG risks are, at least partly, embedded into traditional ones and should be handled in a fully integrated manner. For instance, climate change impacts credit risks by adding to the uncertainties in collateral valuations.

Of course, ESG risks should also be viewed horizontally, where needed with the support of specific methodologies and processes, and this may lead to the outright creation of new risk categories.

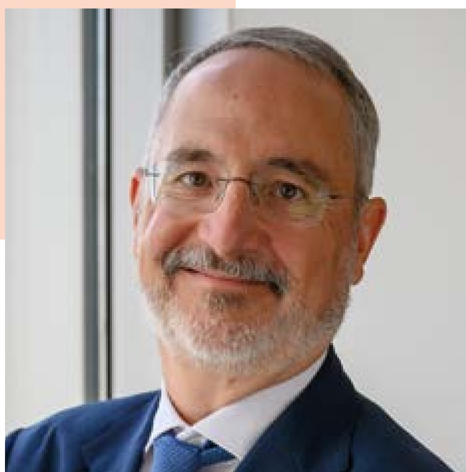
The materialization of these risks – new, accumulated, etc. – will likely occur within different time horizons. For this reason, we are asking banks to conduct frequent, comprehensive ESG risk identification and measurement to estimate the materiality of these present and future risks in a timely manner. This is still a challenge for them in many ways: historical data is lacking, physical and transition risks are not always easy to isolate, technical knowledge is emerging but remains sparse, and mixing long-term macro-economic development and climate impacts within scenarios is not an exact science. Dealing with the different time horizons and the evolutive nature of the different ESG induced risks is still a struggle for some banks.

Comprehensive, integrated ESG risk management frameworks facilitate transition.

Institutions need to work on a long-term risk management effort, with some immediate effects expected. Some progress has happened. For instance, we can observe that banks' governance to address these ESG risks is clearly taking shape. Fewer and fewer banks are considering these risks in parallel, instead fully integrating them into their existing risk management. Institutions objectives, targets, and means are being shared with various stakeholders through disclosures and reporting – such as Pillar 3 disclosures or CSRD - further encouraging if not committing the banks to transition at an appropriate pace. These public commitments are now scrutinised by many stakeholders - investors, supervisors, employees, unions, NGOs, or government agencies. This scrutiny, which has already led to several actions, should limit the risks of greenwashing and foster further integration of ESG factors within the overall risk management framework.

Updated banks' governance with adequate skills and knowledge, holistic ESG risk identification, business environment monitoring, are some of the key ingredients for a strategic update leading to a timely transition.

Are these measures necessary? Indeed. But are they sufficient? Probably not: further progress on risk identification based on more and reliable data, tractable scenarios, enhanced modelling among other things, will provide additional quantitative background to manage those risks appropriately. Continuing coordination between different standard setters and supervisors is also needed. A lot has already been done - this includes updates to the regulatory framework building on the recent banking package, such as new guidelines to banks on the identification, measurement, management and monitoring of ESG risks, currently subject to public consultation - and much more is expected in the coming months and year to further facilitate, support, and foster the embedding of ESG risk by banking groups.



EDOUARD FERNANDEZ-BOLLO

Member of the Supervisory Board - European Central Bank (ECB)

Banks must enhance their climate and environmental risk management frameworks

Since the ECB started to develop a prudential supervisory approach to climate-related and environmental (C&E) risks in 2019, four years after the Paris Agreement, significant progress has been made. Back then, less than a quarter of banks under our supervision had reflected on how the climate and environmental crises affected their strategy. Now, the climate and environmental crises have made it to the top levels within banks and some important steps have been taken. But swifter action is needed, as C&E risks are increasing.

Banks acknowledged the materiality of the climate-related risks in their portfolios in 2022, with 70% seeing material risks within their business planning horizon of three to five years. Encouragingly, over 85% of banks have at least basic practices in place for most of the areas addressed by our supervisory expectations on C&E risks, which we published in 2020. This means that they have performed an initial mapping of their risk exposures, allocated responsibilities within the organisation, set initial key performance and risk indicators, and developed a qualitative mitigation strategy for at least part of their risk exposures.

However, the approaches are inadequate to meet the growing challenges ahead – they still lack methodological sophistication, the use of granular information on risk and/or active management of the portfolio and risk profile. As a result, more than half of the banks under the ECB's supervision are not implementing the practices effectively. Furthermore, some institutions are still lagging behind and have not shown any material progress. We need to push banks to do more, not only from the purely supervisory perspective of ensuring that they are fully aligned with all expectations by the end of 2024, but also from the broader perspective of ensuring C&E risks are adequately identified and managed at a time when science is clearly telling us that the underlying risk factors will only increase. This is why C&E risks continue to be classified as significant and increasing on the SSM Risk Map: there is an increasing likelihood of a disorderly transition materially affecting carbon-intensive sectors, posing challenges for banks and the economy as a whole.

Banks need to effectively implement their climate and environmental risk strategies in line with the EU climate objectives.

Our recent analysis of banks covering 75% of euro area loans shows that currently banks' credit portfolios are substantially misaligned with the goals of the Paris Agreement, leading to elevated transition risks for roughly 90% of these banks. The analysis shows that transition risks largely stem from exposures to companies in the energy sector that are lagging behind in phasing out high-carbon production processes and are late in rolling out renewable energy production. Therefore, banks need to draw up plans to address C&E risks arising from the process of adjustment towards climate neutrality by 2050, which will become a requirement under the revised Capital Requirements Directive (CRD VI). To that end, banks should gather relevant information from their clients and update their risk appetite accordingly. The plans should include concrete intermediate milestones from now until 2050 and develop key performance indicators that allow their management bodies to monitor and act upon any risks arising from possible misalignment with their transition path.

Clearly, this will require significant effort and entail upfront costs. But analysis consistently shows that the benefits of a timely transition far outweigh the costs, especially when assessed against the alternative scenarios of doing nothing or doing too little too late. This is why we are ready to use all our supervisory tools to ensure that banks make this effort. And we are convinced that they can, as the good practices observed in numerous banks demonstrate how the sector can harness innovation to address the prevailing challenges. In 2022 leading practices were observed in 25 out of 30 areas under investigation, including in traditionally more challenging ones, such as data governance, risk classification and pricing. Since then, many banks have implemented good practices to measure and respond to C&E risks, including through client engagement and transition finance. We are therefore confident that a sustained effort can ensure progress towards full alignment with the expectations.

Our goal is to encourage the broader adoption of these best practices, developed by the banks themselves, in order to increase the resilience of the financial system and the economy as a whole.

STEVEN VANACKERE

Vice Governor - National Bank of Belgium (NBB)

No sound risk management unless ESG risks are fully taken into account

Climate-related and environmental risks and their impact on society and the economy are becoming increasingly clear. Physical risks will continue to materialise in the future and will not only have a devastating impact on the environment but will also adversely impact the macroeconomy, thereby giving rise to financial risks. Adaptation is therefore necessary and, in order to mitigate these risks insofar as possible, transitioning to a more sustainable, carbon-neutral economy is vital. Of course, this transition presents its own challenges. Every social and economic sector has a role to play – from the energy sector to manufacturing, transportation, construction, agriculture and forestry. Households and businesses, as well as banks, will need to be prepared.

As a prudential supervisor, it is our role to ensure that the financial system is resilient to climate-related and other sustainability risks. There are some overlaps in how environmental, social and governance (ESG) risks impact financial institutions and how they should be handled. Over the last few years, supervisory authorities and financial institutions have been making efforts to introduce these risks into the supervisory framework at both the EU and international levels.

Thus, since 2023, European banks with listed securities have been required to include information on climate-related and environmental risks in their Pillar 3 disclosures, and financial institutions will soon be obliged to publish information on their sustainability risks and performance in accordance with the European Sustainability Reporting Standards. The fact that their large counterparties will be subject to the same disclosure obligation is of the utmost importance to financial institutions, as this information will allow them to better assess their exposure to these risks.

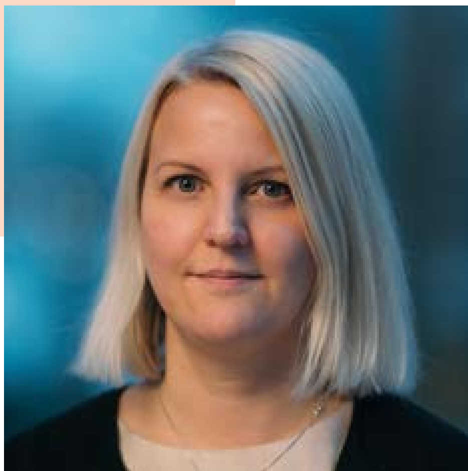
These disclosures will help close data gaps, which are one of the biggest challenges associated with the assessment of ESG risks. Other difficulties are the fact that these risks are unprecedented and that their measurement, materialisation, and timing are subject to substantial uncertainty. Forward-looking measures are therefore needed to assess ESG risks. Scenario analysis and stress testing exercises are vital to understanding and assessing their potential impact. Transition plans are another very important forward-looking tool.

Prudential supervisors need to take the ESG Risks fully into account to ensure sound risk management.

Under the Corporate Sustainability Due Diligence Directive (CSDDD) and the Corporate Sustainability Reporting Directive (CSRD), large companies and financial institutions will be required to prepare and publish transition plans, including the actions taken to align them with major policy targets and how they plan to tackle the challenges resulting from the green transition. The new Capital Requirements Directive (CRD 6) also requires credit institutions to establish prudential plans that indicate how they will address upcoming ESG risks in the short, medium and long term, including those resulting from the misalignment of objectives with relevant policy targets. The EBA Guidelines on the management of ESG risks, published for consultation in January 2024, also contain a number of provisions on these prudential plans.

As a supervisory authority, we are aware of the crucial role played by the financial sector in financing the necessary transition to a more sustainable economy and actively support this transition. We do so not by lowering capital requirements for green products - as these, too, can be subject to risks and prudential regulation needs to remain risk-based at all times - but rather by ensuring that financial institutions adequately measure and manage ESG risks. This will make their portfolios more resilient to these risks and guide their financing and investment decisions. Banks will play a pivotal role in the transition to net zero by providing firms with the necessary funding to reduce their carbon footprint. It is important, however, that these counterparties have credible transition plans in place.

Continued non-green lending without taking into account borrowers' transition plans is no longer compatible with sound risk management. At the same time, it should be clear that while supervisors and financial institutions can and should play a role, it is even more important for democratically elected governments to adopt the most efficient and effective regulatory measures to support the transition, while continuing to tackle the potential unintended effects on society. Consistent and predictable regulation and targets will also help manage ESG risks.



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DNB Bank ASA

Transition plans as a measure to manage climate risk

Climate risk is high on the agenda both for regulators and in the banking sector. The transition to a low-carbon economy will entail transition costs, but also opportunities. The extent of the cost and opportunities will however depend on several factors, and several of these are hard to predict and estimate.

Banks and other financial institutions can, and should, be playing a central role in the transition to a low-carbon economy. Banks are now in the process of trying to understand the financial implications of climate risk on their portfolios, in light of the business environment and economy they operate in. This also feeds into strategic decision making processes where transition considerations are taken into account.

Banks can manage their climate risks by developing transition plans. Over the last couple of years, transition plans have become a mainstream concept in the ESG world, both by regulators and by the financial industry itself. EU regulations, such as the Corporate Sustainability Reporting Directive (CSRD) and Corporate Sustainability Due Diligence Directive (CSDDD), include provisions related to transition plans. In addition, the European Banking Authority (EBA) has recently proposed that banks should develop prudential (transition) plans to address the risks arising from the transition.

In DNB, we have been taking steps to manage the Group's climate risk by developing a transition plan. In DNB, we are strongly committed to our strategic ambition of being a driving force in the transition, as well as to our ambition of becoming a net-zero bank by 2050. We strongly believe that the best path to net zero is the one we create together with our customers, through cooperation and dialogue. Engaging with customers to support their transition is vital to achieve real-world decarbonization.

In DNB's transition plan we have set targets covering around 70 per cent of our financed emissions in our lending portfolio. We have also set targets for our asset management activities, where we invest on behalf of our customers (via DNB Asset Management, DNB Livsforsikring and DNB Næringseiendom) describing how we'll use our position as an investor to drive real-world impact on emissions reductions.

This transition plan is an important strategic tool that helps us understand the business implications of our net-zero commitment, to navigate the challenges and opportunities presented by climate change, and the transition to a low-carbon economy. It sets out how DNB will drive the transition, and the tools we have at hand to engage with and guide our customers and the companies we invest in towards reducing their greenhouse gas emissions.

Institutions must be given flexibility and responsibility in their transition planning.

At the same time, the transition plan highlights key dependencies and external factors that are crucial to achieving our targets. Factors beyond our control will influence the progress we make and our ability to reach our targets. Collaboration and active engagement with public and private actors will be vital for ensuring a successful transition.

Even though the direction is clear, we must also acknowledge that future emissions reductions will most certainly not be linear. From one year to another, we may even see an increase in financed absolute emissions in certain sectors. For this reason, our transition plan is dynamic, and will be reviewed and revised following progress on data quality, methodology and other material developments.

The global community will face several dilemmas on its journey towards net zero. As a financial institution, we need to balance the needs, demands and expectations of all our stakeholders when we make decisions – whether they are corporates, consumers, regulators, employees, or owners. We also need to strike a balance between a fast transition and a just transition – by taking human rights and impact on nature into consideration when developing new energy sources, for example.

The impact of climate change is also expected to vary substantially across the world. In addition, the exposure to high emitting sectors differs between countries and regions. As a leading Norwegian bank, we're a reflection of the Norwegian economy, with a large share of fossil fuel related industry. As such, we need to strike a balance between the aforementioned considerations and the need for energy security through the transition. The dilemma of energy security vs. national climate targets became clear when Norway had to step up to become Europe's largest supplier of gas in a critical phase following Russia's invasion of Ukraine. Our strategy is to work together with our customers through the transition – and to finance and advise on real-world decarbonisation, rather than exiting carbon-intensive sectors.

These dilemmas need to be acknowledged and it is important that the financial institutions are given a reasonable amount of flexibility and responsibility in their portfolio steering and transition strategies.

HARM BOTS
President - MUFG Bank Europe and Chief Executive Officer, Head of EU

Transition plans are not a risk management tool

Transition plans are now a well-established concept for G-SIBs committed to net-zero. Some of us have already published a transition plan, some of us are still in the midst of designing the strategy. This is a key priority for banks' management. Transition plans show the crucial role financial institutions play in enabling real economy transition. We should be clear about what transition planning really is, which is not about greening the bank's balance sheet only but is about ensuring we can achieve a low carbon and sustainable economy.

There is an important role to play for our climate risk management framework, which functions as a guardrail to understand where the key exposures are with respect to physical and transition risk. But transition planning should not be seen as a risk management tool, it is a business strategy. Therefore, it is important that any prudential treatment or policies in this area take this crucial role into account. This is particularly important for global banks operating in different regions characterized by different challenges.

At MUFG, the essence of our transition plan is our ability and willingness to support our clients towards their transition to net-zero, including in hard to abate sectors. We are engaging especially with our clients in sectors like power, oil and gas, steel, shipping and real estate. For global banks operating across various countries, this sectorial client engagement is conducted across various geographies, posing different challenges. However, it is not about cherry picking certain sectors from which to divest our existing exposures for the purpose of achieving carbon neutrality on paper. We help all clients to transition away by investing in technologies that can help them to achieve their net zero strategy. Only this approach will help us greening both the economy and our balance sheets. This is a key element to understand: for banks, the transition of our clients is our transition.

Both at the EMEA and global level, senior MUFG leadership is actively involved and responsible for the overall transition planning process, considering the different challenges across the regions we are operating in. In April, we are planning to present our first group transition plan which will summarise the results to date of our transition planning process and further detail our transition to a net-zero strategy. This includes tangible strategies to achieve our sectorial interim emission reduction targets.

As stated earlier, climate risk management plays an important role in assessing the part of our balance sheet which is 'at risk' and may pose financial stability concerns and therefore needs the most attention in terms of transition financing. However, climate risk management is about ensuring we manage and to some extent mitigate the climate related risk on our balance sheet. A transition strategy ultimately is a business opportunity strategy, it is not a risk management exercise and the two should not be conflated. We take note of the recent developments where transition seems to be characterised by supervisors and regulators as a silver bullet for achieving net-zero and a risk management tool.

The Basel Committee has published a consultation paper outlining the disclosure requirements, including transition plans and financed emission "forecast". In Asia, the Monetary Authority of Singapore has published a consultation paper on transition planning. The Financial Stability Board has set up a working group to discuss how transition plans can be used to monitor "macro prudential" implications of transition. In our opinion, using transition planning for the purpose of supervisory risk oversight could raise some concerns and it seems there is a gap between how banks view transition planning in strong engagement with the real economy and how regulators seem to be using the concept for effectively driving only banks to green their balance sheet, leaving the hard to abate sectors at the risk of not transitioning at all.

We agree that financed emissions (scope 3) of a bank is an important data point to understand the focus of banks' transition strategy, however it should not be used as a tool for how the bank is managing its climate risk. For example, supporting the real economy transition actually means in certain sectors that responsible banks with very sound risk management frameworks need to take on additional risk to ensure that hard to abate sectors can achieve their transition strategy.

Transition planning is a growth story, not a compliance exercise.

To conclude, we view transition planning as a growth story, not a compliance exercise. We strive to move forward in our path to transition and we urge all involved parties to ensure that as enablers of financing for the real economy, we are able to continue to support our clients transition at the global level while ensuring the stability of the financial system. Climate change and the necessary transformation of our economy is the main challenge of our time and needs the collaboration among all the parties involved.

JULIA SYMON
Head of Research and Advocacy - Finance Watch

Reconciling prudential measures with climate science

As the world, including the European economy, remains largely unsustainable and global greenhouse gas emissions continue to grow, climate-related risks in the banking sector remain high. Being the main providers of finance to the real economy, banks are exposed to transition risks associated with transformations needed in the economy to achieve the EU Climate Law objectives and international commitments. Recent estimates of the European Central Bank and European Systemic Risk Board (ECB/ESRB) indicate an elevated level of transition risk in the EU banking sector, as "the share of high-emitting economic sectors in bank lending is around 75% higher than its equivalent share in economic activity". The level of physical risk is also increasing, as the required emission reductions have not yet set it. Consensus is growing among scientists that the world is headed for a "hot house" scenario with average temperatures exceeding preindustrial levels by 3°C.

The 2023 UN annual Emission Gap Report, which assesses countries' climate policies compared to the required changes, confirmed this. Once critical temperature thresholds are exceeded, physical risks will be severe and non-linear, with disruptive and irreversible consequences.

Regulators and supervisors have long recognised that climate change represents a major threat to financial stability. There is also a recognition that due to the unprecedented and forward-looking nature of climate risk, reliance cannot be placed on historical data to measure this risk, giving rise to a high degree of uncertainty. Complex interlinkages between transmission channels, feedback loops between physical and transition risks, longer time horizons and the non-linear nature of climate effects pose major challenges when modelling climate risk and designing tools to address it. Despite these challenges, supervisors have reached a clear conclusion: There are clear benefits to acting early, as the cost of unabated climate change will by far outweigh the cost of timely regulatory action.

In search of prudential measures to address climate-related risk, regulators have so far focused on disclosures and qualitative principle-based requirements. They deferred more decisive action in expectation of more precise climate risk measurements. Yet, the models used to estimate the economic impact of climate change have so far predicted only a benign level of economic losses and, thus, benign effects on the banking sector. These models – known as dynamic stochastic general equilibrium models (DSGE) and integrated assessment models (IAMs) – were developed to deal with traditional financial risks and are not suitable for climate-related risks. They rely on backwards-looking data and make assumptions about economic equilibrium that may no longer apply, as climate-related impacts will be disruptive, unpredictable and permanent. Tipping points and feedback mechanisms, such as melting permafrost or the slowdown of the Atlantic Meridional Overturning Circulation could accelerate losses to levels far above those from recent financial crises.

Realistic estimates of the economic losses of climate change should guide regulatory action.

All supervisory climate scenario analyses use these models and, as a result, their estimates of the economic losses of climate change are clearly at odds with climate science. A major modelling flaw is the assumption that economic damages from climate change are a quadratic function of the warming level. This leads to unrealistic conclusions: In the scenarios used by the Network for Greening the Financial System (NGFS), "an increase in global mean surface temperature by about 3.5°C until the end of the century would reduce global output by 7-14% in 2100". Furthermore, the existing models ignore some of the most severe impacts of climate change. Notably, NGFS's recent estimate of climate losses excluded costs arising from extreme weather, sea-level rise, migration and conflict.

Notwithstanding the usefulness of climate scenario exercises for supervisors, their outputs have sent the wrong message to policymakers, fuelling inaction. If the economic impact of climate change continues to be underestimated, cost-benefit analyses of prudential policies will be distorted. Inaction will reduce the future resilience of the financial system risking a major financial crisis.

There needs to be a radical rethinking of the approach to climate scenario modelling. Further, acknowledging model limitations and the systemic nature of climate-related risks, precautionary holistic regulatory actions need to be taken. Ensuring adequate capitalisation of banks to cover future climate-related losses requires overcoming limitations of the existing prudential requirements, which are calibrated based on historical data and are largely based on one-year time horizons.

Finally, transition plan requirements for banks should be robustly defined to make banks effectively contribute to climate risk mitigation via real world decarbonisation.