Sustainability risks in the banking sector

Introduction

The Chair stated that climate is a global issue that demands global solutions and international cooperation. The financial industry is at the centre of this challenge. Both industry and supervisors are trying to find concrete solutions to improve the assessment and management of climate-related risks that could fuel major global financial crises.

1. Banks' journey to address sustainability risk is far from finished

1.1 Banks started embedding sustainability risk in disclosures, decision-making processes and customer interaction. Further improvements are necessary, however, on data, risk coverage, measurement, and transition planning, while operationalising sustainability risk approaches in day-to-day as well as strategic decisions across organisations raises unprecedented challenges

A regulator emphasised that this is a process in which European society can provide a strong push. There is a perception that Europe is arriving too late to this problem, and that there is a need to do more and to act more quickly.

There have been improvements in the banking sector over the last three years. Sustainability concerns have been considered at all governance levels within institutions. Many institutions already have sustainability committees and are addressing sustainability issues. They also consider ESG risks when they address customers. Institutions are enhancing disclosures. In early 2023, some Pillar 3 requirements were put forward. A substantial amount of regulatory work on disclosures is being put forward and will need to be implemented. The International Sustainability Standards Board (ISSB) is working on international disclosures.

However, all these areas require enhancement. It is necessary to enhance modelling techniques and risk measurement methods, with appropriate integration into the day-to-day management of institutions. The ability to obtain relevant data from counterparties must be enhanced across the whole of society. The Pillar 3 disclosures contain a green asset ratio that addresses only a very small part of the banks' activities. For other activities, there is currently no methodology available to assess banks in terms of willingness. Risk modelling is very important. The European Banking Authority (EBA) is working on guidelines for stress testing on climate risk and sustainability. As this is further built into the regulatory framework, it will be important to use forward-looking data methodologies.

A Central Bank official observed that it is now clear that the current global path on climate is not sustainable. The ECB's main concern is to operationalise the consciousness of problems that banks already have. In banks, operationalising is about money and real-life decisions. The ECB is trying to push banks forward on the assessment of materiality, risk frameworks and strategy.

There is currently no requirement to have a transition plan. Transition planning serves a wider economic purpose. The ECB's minimum requirement is for risks inherent in the transition to be measured. In the ECB's recent appraisal, published this year, it was observed that many banks are not yet trying to construct proxies of their portfolios to see how they evolve. Progress is needed here, independent of legal obligations to conduct transition planning.

1.2 Learning by doing and disseminating good practices are the best approaches promoted by the ECB to progress

A Central Bank official stated that the ECB is trying to lead by example. It has published an example of methodology. The purpose of this is not to be prescriptive; rather, it is to be transparent about a possible approach that has been identified. This is a frontier that the banking system will need to cross soon. Dialogue is the ECB's first approach. If dialogue does not result in delivery, then pressure will be exerted.

1.3 However, global standards are necessary

An industry representative stated that further work on operationalisation is needed. Climate risk cannot be addressed through local solutions, so the EU needs to help drive global standards.

2. Climate risk and a net-zero transition plan are becoming core management features

2.1 Climate risk and a net-zero transition plan clarify key dependencies and external factors essential for banks cooperating with both customers and policymakers

An industry representative commented that banks are now trying to understand the financial implications of climate risk. This analysis will feed into strategic decision-making processes. In working on climate risk and the net-zero transition plan, several key dependencies and external factors have been encountered. Future emission reductions will not be linear. There may be an increase in financed emissions in certain sectors. Supporting customers through cooperation, financing and dialogue is key. Collaboration and engagement with public actors will also be vital in ensuring a successful transition.

An industry representative observed that transition plans and climate risk are becoming core concepts for all managers of banks.

2.2 The challenge for banks is to combine the mitigation of sustainability risk with an appropriate contribution to the net zero transition of the real economy. Supervisors should better understand related constraints

An industry representative stated that the risk management function should enable transition risks to be identified and quantified. New measurement tools will allow risk appetites to be appropriately set, preserving financial stability. The objective of transition planning and climate risk management should not be conflated with the work on transitioning the real economy. Climate risk should be approached similarly to other drivers of traditional financial risk.

Financed emissions or scope 3 are important data points to consider, but this is to understand a bank's focus on transition planning and to understand where the key climate risks are. Financed emissions should not be used as a proxy for climate risk. Transition finance is needed hard-to-abate sectors decarbonize, which might mean financed emissions increase temporarily. This can be done with confidence if the risks are well understood, and the risk profile is appropriately set.

Banks have a unique role to play, as they are in direct dialogue with clients and understand the challenges faced by clients in different jurisdictions. Banks need ongoing dialogue with their clients to understand whether transition plans are ambitious enough and whether transition risks are being managed. Transition planning is an important risk framework; on the other hand, the important activity that banks need to undertake is around supporting clients through transition in a safe manner.

Given the significance of the problem, all actors need to come together. Banks have a responsibility to navigate the process safely, working with regulators and supervisors. Banks have an important role to play as enablers of this process, mobilising private and public capital. Banks need to have well operationalised, well developed risk frameworks.

2.3 Banks are improving transition planning by doing; however, a more global and consistent approach is necessary, which should factor in that the road to net zero is not linear, and that flexibility and realism in banks' transition planning is important since transition plans have to feed into banks' day-to-day lives

An industry representative stated that MUFG will publish its first global transition plan in April. This is a continuous process, based on intense dialogue with clients. The more the standards and methodologies are applied globally, the more effective banks can be in ensuring that transition plans provide all necessary information. The transition plan needs to be further hardwired into the core risk management mechanism.

An industry representative commented that DNB's transition plan was launched in October 2023. This is an important strategic tool in understanding the business implications of the net-zero transition. In the transition plan, DNB has set science-based targets covering around 70% of financed emissions in its lending portfolios. Targets have been set for asset management activities. There are several relevant external factors. A balance must be struck between a fast and a just transition by considering the impacts on nature and human rights. The impact of climate change will vary across the world, as exposure to high-emitting sectors differs substantially between countries and regions. Energy security must be considered throughout the transition. The road to net zero is not linear, so flexibility in banks' transition planning is important.

A Central Bank official stated that the transition plans of listed companies should be strategic and cohere with ambitions. The transition plans of banks should be risk-oriented and acknowledge that greening the economy means working with sectors that are not yet green.

A consumer representative commented that transition plans are important strategic and risk management tools, giving information about a bank's portfolio and potential transition risks. They can also provide important supervisory information. For transition plans to work, they should focus on mitigating the transition risks inherent in client business models. Client engagement should be credible, following up on stated ambitions. Speaking about transition plans as one disclosure and risk management tool is important to contextualise emission metrics. A baseline is needed for how transition plans should be built and which scenarios to use, so that banks' performance can be credibly compared.

A regulator emphasised that transition plans are operational tools.

A Central Bank official stated that plans need to be consistent and operational in day-to-day life.

3. Defining realistic and useful stress scenarios is challenging

The Chair noted that several stress tests have been implemented. Progress has been made in the definition of scenarios and the refinement of approaches. Such tools are essential to enhance the forward-looking elements of the prudential toolset.

A Central Bank official stated that stress testing should be about the real economy. It must be recognised that the materialisation, measure, and timing of the impact is subject to substantial uncertainty. Some modesty is necessary. The purpose of scenarios is to get as close as possible to reality. Even though stress testing is forward-looking, it is often based on historical data. Trying to imagine scenarios and get as close as possible to the what-ifs is often more thought-provoking than conducting an administrative exercise.

3.1 Various stress scenario shortcomings need fixing: data availability, interconnectedness, the consequences of protection gaps, while preserving workability and banks' agility

A Central Bank official observed that there are still shortcomings relating to scenario exercises. Data availability is still an issue, although this is improving. It is questionable whether second-order effects and interconnectedness across the financial sector are truly being integrated. In countries where the protection gap in insurance is large, banks might be confronted with the results of the absence of enough insurance in another part of the financial sector. These elements may not be sufficiently integrated in scenarios.

There is another flaw that organisations like the Network for Greening the Financial System (NGFS) are working on. These exercises usually have a long-term focus. They work by considering static balance sheets, assuming that banks are not going to react and that all incidents will occur instantaneously. In reality, balance sheets are likely to adapt. Combining a long-term scenario with short-term assessments might significantly improve these scenarios.

An industry representative stated that opportunities will emerge as banks get better at measuring risk and advancing the available toolkit. The current formats are not perfect, as nobody has yet lived through the climate transition. To play a role in enabling the real economy to transition, banks need to be good at measuring and managing risks. Agility is needed to respond to new insights. MUFG has produced two Japan-focused white papers, leading to many insights about transition pathways, the challenges faced by clients, the technology needed to resolve issues, and the associated risks. The stronger the risk toolkit is, the more confident banks can be about helping the real economy to transition.

3.2 At present, some consider that existing stress scenarios give an inappropriate sense that climate related risk is benign. Yet climate related stress scenarios should address various challenges: banks' dependence on transition policies, an uneven assessment of these risks which lacks comparability, the short-term focus of bank management

A consumer representative stated that a radical rethink of the approach to climate scenarios and stress testing is needed. It is important to continue working on these scenarios, while also recognising that climate and economic systems are highly complex. It is not easy to build a model that incorporates everything, given the problems with collecting data and reflecting complex interactions between the environment, economy, and the financial system. The scenarios conducted to date clearly concluded that timely actions are needed to address climate-related risks as the cost of inaction clearly outweighs the cost of timely action. The actions that would facilitate a timely transition would be better for financial stability than delayed or no action. However, the predicted losses to the financial system from those scenarios are benign. This has led to a false sense of security.

Fundamental flaws in the scenarios have been identified. The scenarios used by the NGFS are based on the economic models put in place to analyse traditional financial risks, which are, however, not suitable to analyse economic effects of climate change. These models usually assume general equilibrium in the economy, which will not be the case if the world is disrupted by climate change.

One example is the damages assumed in the economy because of climate change. Most models use the quadratic damage function, so losses are assumed to be quadratically dependent on the rise in temperatures. This leads to the conclusion that, by the year 2100, a rise of 3.5 degrees Celsius will lead only to a GDP loss of 7% to 14%. This is clearly at odds with what climate scientists are saying. Most scenario analyses exclude the gravest impacts of climate change such as sear level rise, extreme weather events and mass migrations. If the estimation of the cost of action versus inaction is not rethought, there will always be a tendency towards inaction or milder measures.

A lot depends on governments. Leaving institutions to navigate uncertainty and provide measurements is not sufficient. Many meaningful climate-related risk management principles with meaningful frameworks. These principles stipulate that risks must be identified and then either be mitigated, or there must be adequate capital to bear the risk that cannot be mitigated. This is the basic framework for banks. However, in the case of climate-related risks individual institutions lack the capability to apply this basic framework. Climate-related risks will also be systemic so it is important to turn to the tools that can address this issue, and address short-termism, which prevents the incorporation of climate-related risks into today's decisions. If all banks continue to delay acting, the risks in the system will remain.

There are macroprudential tools that are designed to address these challenges. In the banking sector, these tools are well defined and able to prevent the build-up of future risks, although there are still many questions regarding how these tools should be calibrated. It is clear in which sectors there will be concentrations of exposures that will be subject to high transition risk. Metrics on alignment are also very important. Work should continue evolving the macroprudential framework to account for the need to use forward-looking information and to establish robust methodologies for transition risk metrics. In case of credit risk, probabilities of default (PDs) and loss given defaults (LGDs) are the relevant indicators, widely recognised and used by all industry participants. In case of climate risk, the indicators are not yet widely established. It is necessary to continue this work, while also turning to macroprudential tools and starting to mitigate the risk proactively.

3.3 Existing climate related EU policy, namely Fit for 55, and the ability of the economy to implement it, are key features of the stress test scenarios in the EU

A regulator highlighted that the EBA is currently running a joint stress test assessment on the financial sector with the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA), with support from the ECB. The scenario is about a climate risk policy, namely the Fit for 55 strategy. It is important to consider not only the banks and the financial sector, but the economic policy towards climate and how this impacts the financial sector.

With the introduction of ESG risks in the current Basel III CRR III/CRD VI package reform, one key component is that banks consider climate-related sectoral policies when assessing risk. This joint assessment considers the European financial system's ability to achieve the Fit for 55 strategy, and the potential risks that may apply. There are two scenarios: one in which the transition is smooth, and another in which it is not. The approach is bottom-up rather than top-down. This is not about asking individual institutions to provide information; the aggregate concern is more important. Finally, the approach is about trying to assess cross-sectoral linkages.

Banks need to properly assess risk, including climate risks and policy-related risks. It is necessary to ensure that these two elements are intertwined. The third aspect is to ensure that the regulatory framework is adjusted to properly address risks when considering the prudential framework.

3.4 An essential added value of climate-related stress tests is to trigger strategic and operational adaptations within EU banking groups

A Central Bank official stated that the main issue is to operationalise the effect on the day-to-day lives of banks. In 2022, only 40% of banks had developed internal stress tests integrating climate, and only 20% were accounting for stress test results in their loan granting processes. The goal is for everybody to take these risks into account in their day-to-day lives. In 2024, the situation is better, as the results of this exercise are being followed up on. In 2022, even the 40% of banks that had internal stress tests did not include reputational risk. Policy was almost entirely lacking. Supervisors have more freedom to devise scenarios.

3.5 The many ways in which a bank can incorporate climate-related risks, which only materialise in the long term, into its strategy in the short or medium term raise issues and feed the sense of risk benignity

A Central Bank official noted that bankers might have a portfolio of credits in a risky sector for the next four or five years. If it is explained to these bankers that they will be in trouble in 10- or 20-years' time, they will not worry, as they have time to adapt their strategies. It is important to identify the long-term challenges that are societal and common to all. Not taking the long term into account can perhaps be a temporary business strategy, but it can't be a societal one.

A Central Bank official emphasised that the ECB stress test had a three-year horizon. This is why the results were found to be so benign by some observers. While the risk is lower within the three-year horizon, there is an expectation to take immediate action.

4. Forthcoming regulatory evolutions foreseen in a vibrant EU climate-related regulatory landscape

A regulator stated that, regarding the prudential banking regulatory framework, the disclosure requirements are now applicable on Pillar 3. As banks consider Pillar 2, they should incorporate ESG in all relevant risk aspects. The guidelines on ESG governance are being adjusted. Guidelines are also being adjusted to ensure that ESG issues are assessed when loans are originated, and that ESG risks are introduced when remuneration is considered. The internal capital adequacy assessment processes (ICAAPs) and supervisory review and evaluation process (SREP) guidelines are important.

The EBA confirmed its views on Pillar 1 requirements in its autumn 2023 report. Pillar 1 is a regulatory framework, so it is important to be sure about what to put into it when it is embedded. To make that step, it is first necessary to assess additional risk and how it is materialised concretely into banks. The report contained some short-term ideas that can be implemented, but the medium and long term require further analysis. Another aspect to consider is the way in which this is built into the regulatory framework. It cannot be based on the use of historical evidence. Scenario stress testing must be used to properly assess risks and to include them in the Pillar 1 framework.