

## SUSTAINABILITY RISKS IN THE BANKING SECTOR



### FRANÇOIS- LOUIS MICHAUD

Executive Director –  
European Banking  
Authority (EBA)

### Greenwashing: a sustainability challenge for the banking sector

The EU sustainable finance market is growing rapidly as consumers, investors, and other market participants are increasingly seeking to align their financial decisions with environmental and social objectives. However, this also poses a major operational challenge for banks and financial institutions in the form of an ever-possible risk of greenwashing. Greenwashing refers to the practice of making sustainability-related statements or claims that do not reflect the actual sustainability profile of an entity, a product, or a service. This can mislead the market and undermine the credibility, reputation, and performance of the entire financial sector.

Greenwashing is not a new phenomenon (some claims were noted already 20-30 years ago) but it has come to the

surface more prominently in recent years with a growing demand for green and sustainable products and services and increased public awareness of sustainability issues. This increased demand for green and sustainable products has resulted in the market creating and offering more of these products and services, which itself tends to fuel additional demand.

This is of course a very welcomed change. Until it is not. And it is not welcomed if one discovers that “green” or “sustainable” is only a façade with not much greenness or sustainability behind it. With increased public awareness and reporting on it in the media, this may shed a dim light on the transition to green and sustainable economy. Moreover, this may create new risks for the financial sector, which require increased monitoring.

Increased allegations and evidence of greenwashing were one of the reasons why two years ago the European Commission asked the EBA, EIOPA and ESMA (the three ESAs) to investigate the phenomenon of greenwashing in the financial sector and to make recommendations to address it. Their contribution was published in June 2024 with the EBA’s report focusing on the banking sector as its main remit. It is a comprehensive and timely contribution to the EU’s sustainable finance agenda.

How can banks and financial institutions prevent greenwashing?

As shown in the EBA’s report, the number of alleged greenwashing cases in the EU and globally have increased significantly in the last decade – 7.3 times between 2012 and 2023 – and the increase includes the financial and banking sector. This reflects the rapid growth of sustainable finance products and services, such as green bonds, sustainability-linked loans, or green deposits, as well as the rising expectations – and attention – of consumers and investors regarding sustainability information and performance. From a financial risks perspective, greenwashing entails first and foremost reputational and operational risks including litigation risk for individual firms and can also result in financial stability concerns through an inadequate allocation of capital and pricing of risks.

The EBA considers that the EU has already put in place a robust regulatory

framework to address greenwashing, based on two key pillars: consumer and investor protection, and sustainable finance. The former sets out rules and principles to ensure that sustainability information is fair, clear, and not misleading, while the latter provides common definitions, standards, and disclosures to enhance transparency and comparability of sustainability practices and products. On the other hand, some of these regulations are still in the early stages of implementation, while others are being updated or developed, suggesting that their full benefits are not visible yet.

Financial institutions are the primary responsible for ensuring that their sustainability claims are accurate, substantiated, up-to-date, understandable, and that they fairly represent the actual sustainability features. To this end, the EBA provides guidance on best practices to mitigate greenwashing risk at both the entity and the product level, for instance through governance, data, external verification, and forward-looking commitments. The EBA urges institutions to review and, if necessary, adapt their internal processes and arrangements to prevent and detect greenwashing, and to fully integrate greenwashing-related financial risks in their risk management.

The EBA itself is also committed to tackling greenwashing by providing regulatory guidance on how to address it through prudential supervision. This should be done facilitating knowledge-sharing among supervisors on best practices and monitoring greenwashing-related trends and risks in the EU banking sector. The EBA is also developing specific requirements for banks to assess and manage financial risks resulting from greenwashing or greenwashing allegations as part of its forthcoming Guidelines on the management of ESG risks.

All in all, greenwashing is not only an ethical issue. It is also a strategic and operational one, that requires a comprehensive and coordinated response from all stakeholders. By addressing greenwashing effectively, institutions, supervisors, and policymakers can enhance the credibility and integrity of the financial system, foster consumer trust and confidence, and support the transition to a more sustainable economy.



## ELIZABETH MCCAUL

Member of the Supervisory Board, ECB Representative – Single Supervisory Mechanism (SSM)

### Operationalising climate-related and environmental risk management

Five years ago, less than a quarter of the banks under our supervision had incorporated climate-related and environmental (C&E) risk in their risk management frameworks. We have come a long way since then. Most banks have now drawn up materiality assessments that are aligned with our supervisory expectations. But this is only a first step, and much more work lies ahead.

Banks continue to face challenges in operationalising C&E risk management and ensuring comprehensive coverage of all C&E risk categories. This especially concerns integrating physical risks alongside transition risks and applying forward-looking data.

C&E risk, by its nature, is a forward-looking risk characterised by uncertainty. This uncertainty stems not only from the physical impacts of climate change but also from policy changes in the transition towards a decarbonised economy.

To navigate this uncertainty, banks need robust tools and methodologies. One effective approach is what is known as

an alignment assessment. This measures transition risks by comparing the projected production volumes in key economic sectors with the required rate of change to meet given climate goals. This method allows banks to anticipate and prepare for potential changes, which makes it the best available tool for forward-looking risk assessment.

Banks have started to deploy alignment assessments broadly, incorporating various good practices to enhance their effectiveness. In early 2024, we published a report entitled Risks from misalignment of banks' financing with the EU climate objectives that outlines some of the best practices. These include:

- Selection of representative scenarios: The scenarios should be science-based and consistent with stated policy objectives such as those formulated in the Paris Agreement.
- Consistency of choice: Scenario choices used for strategic planning, risk management and disclosures should be internally consistent and well documented.
- Re-baselining: The scenario should be up to date, and the choice of base year should be well justified. If an analysis is updated, the base year of the decarbonisation pathway should be aligned with the year of the analysis.
- Geographical relevance: The scenario should be geographically relevant to the portfolio under consideration.
- Annual updates: The scenarios should be updated on an annual basis to incorporate global events, changes in the carbon budget and technological developments.

Despite these efforts, misalignment can still occur. The ECB's report on good practices for climate-related and environmental risk management sets out ways that banks can effectively deal with the risks of such misalignment.

Transition planning should become a cornerstone of standard risk management, linking banks' assessment of material transition risk drivers, strategic targets, risk appetite frameworks, risk management tools and the wider organisational set-up. For example, some banks have started managing transition risks by introducing active client engagement and offering transition finance products. Banks can enter a structured dialogue with their clients to steer them towards a trajectory that is aligned with the envisaged portfolio pathways. There are also synergies in the parallel management of transition and physical risks at client level, which could also be leveraged by means of sustainable

financing products. These examples show that progress is possible.

At the same time, we acknowledge that challenges related to data and methodologies persist. The ECB has publicly supported policies to improve data availability for the purposes of C&E risk management.

For example, our opinion on the revised Energy Performance of Buildings Directive (EPBD) expresses our support for the aim of the EPBD to improve access to energy performance certificates and stresses the need for credit institutions to have access to that information. We also called for harmonised methodologies across the EU to foster comparability and reliability.

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**2024 is a pivotal year for banks to become more resilient to C&E risks.**

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Another example is the proposed ESG Rating Regulation. Our opinion highlights that increased transparency together with increased reliability and comparability thanks to comprehensive disclosure standards will help facilitate the use of ESG ratings as an input factor in banks' monitoring processes.

2024 is a pivotal year for banks to become more resilient to C&E risks. By the end of this year, we expect all banks under our supervision to be fully aligned with all our supervisory expectations on the sound management of C&E risks. This requires ongoing refinement of materiality assessments, integration into business strategies and rigorous risk management practices. ECB Banking Supervision will continue to push banks and thereby to ensure that the banking system remains safe and sound as we transition to a net-zero world.



## CSABA KANDRÁCS

Deputy Governor –  
The Central Bank of Hungary

### Climate risks and capital requirements: possible solutions from Hungary

In recent years, climate change and environmental risks have emerged as primary concerns for central banks and supervisory authorities. A decade ago, few would have considered incorporating environmental risks into the capital requirement framework, and the idea of giving central banks a sustainability mandate seemed far-fetched. However, the landscape has changed dramatically. Today in Hungary, green exposures benefit from preferential capital requirements, and the central bank holds a sustainability mandate, highlighting the significant shift in priorities.

The Magyar Nemzeti Bank (MNB – Central Bank of Hungary) has put in a lot of efforts to build a well-functioning green finance ecosystem in the country. Consequently, sustainability now permeates various activities at the MNB. To lead by example, efforts are being made to reduce greenhouse gas emissions of own activities and offset the remainder. We set supervisory expectations to enable banks to mobilize sources to green activities. There is also a focus on building sustainable finance

capacities. Crucially, these actions are undertaken without compromising the stability of financial institutions or the financial system.

Traditionally, capital requirements have been risk-based, and they should remain so. However, the emergence of climate risks as new risk drivers necessitates that financial institutions prepare to cover unexpected losses stemming from transition or physical risks. In 2020, as an initial step towards sustainability, the MNB began developing climate risk stress testing capabilities to assess risks in the financial sector comprehensively. These tools have been continuously refined to measure both physical and transition risks over short and long term. The results have revealed significant forward-looking risk differences across sectors and companies in the real economy. Fortunately, these risks are not concentrated, ensuring that Hungarian banks remain stable even in severe transition risk scenarios. To prevent substantial concentrations from building up in individual institutions' balance sheets, the MNB will require banks to conduct rigorous climate stress tests. These tests will assess exposures to climate risks, as outlined in the central bank's green supervisory expectations. Banks are also expected to integrate climate risk assessment into their general risk management processes to further strengthen the stability of the sector.

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Maintaining a risk-based approach implies that lower risks should lead to lower capital requirements. Based on the green hypothesis that green loans and firms bear less credit risk, the MNB introduced a unique green preferential capital requirement program. Green exposures can receive substantial deductions from their Pillar 2 capital requirements, with eligibility criteria based on the EU Taxonomy. Although the central bank has approached this preferential treatment cautiously—setting caps on deductions and limiting the timeframe—the initial empirical results align with expectations. The credit risk of green exposures has proven significantly lower than their benchmarks. This is a very promising result since banks tend to allocate credit towards less risky companies and a capital deduction can further mobilize

funding to sustainable investments. The program's performance will be closely monitored to inform international discussions on capital requirements.

Nature-related risks have also gained attention as financial risk drivers for central banks and supervisors. The MNB is at the early stages of addressing this challenge. In collaboration with the OECD, the central bank recently completed a milestone project to assess financial risks resulting from biodiversity loss. Moving forward, the main questions will be how to tackle this new challenge and whether it is necessary to implement changes to supervision processes.

Finally, I would underline the importance of clear regulation of the real economy in combating climate change and environmental degradation. Forward guidance in monetary policy is a well-established tool for managing investors' expectations. Similarly, it is crucial to provide clear signals to the market about future regulations concerning climate change and the environment. The greater the uncertainties surrounding future policies and regulations, the greater the transition risks we will face.

While central banks can support an orderly transition, governments must take the lead in this endeavor.





## HIROHIDE KOUGUCHI

Executive Director –  
Bank of Japan

### Need for a more pragmatic approach on sustainability risks

Sustainability risks, especially climate-related risks, continue to be the most significant risks on the globe and have material implications on global financial stability. In the APAC region, as in the rest of the world, we are observing increasing natural disasters, such as heat waves, devastating typhoons, floods, landslides, droughts or wild fires. The damages caused have become more exacerbated. In this regard, sustainability risks are becoming imminent risks, rather than middle or long-term risks. On the other hand, the global track record of GHG reduction or the development of temperature has not been prospective so far, partly due to the global economic recovery from COVID-19 and the rise in geopolitical tensions.

I highly appreciate the significant contributions achieved to date by the global fora, regulators/supervisors and standard setting bodies, to cope with sustainability risks. However, in order to address the above-mentioned challenges and move things forward, we need a more pragmatic approach. I wish to raise three points.

First, scenario analysis should be more pragmatic and realistic. When

we assess the impact of sustainability risks on financial system, scenario analysis is very useful. That said, it is a remarkably challenging task to establish plausible scenarios and appropriate models to evaluate sustainability risks. This is because the time horizon is typically 30 to 50 years and in addition to insufficiently granular data, we face a wide range of uncertainties with technology, regulations, behavior of firms and households, and structural change of economies down the road that need to be accounted for in the many parameters of the model. Furthermore, the impact of change in temperature may be non-linear, adding to complexity. In addition, our recent experiences shed light on the potential trade-off between economic growth with price stability and sustainability risks. One approach to deal with these challenges may be utilizing the alternative scenarios that explicitly show changes in temperature, economic growth and prices assuming demand and supply side structural changes. By comparing these scenarios, policy makers can understand the extent to which the scenarios are plausible or acceptable to the public. This will contribute to well-balanced policymaking. Another approach may be utilizing short-term scenario analysis, taking into account the current economic structure in each jurisdiction to understand propagation dynamics of sustainability risks. In this regard, the Bank of Japan published the short-term scenario analysis utilizing the input-output matrix. Continuous enhancement of short-term analysis may give us pragmatic insights on long-term analysis.

**As sustainability risks have become more imminent, it is time to seek a more pragmatic approach.**

Secondly, transition finance is a key factor in a pragmatic approach. Transition finance plays a critical role in achieving material reduction of GHG emissions by orderly business transformation of GHG intensive industries, while also enhancing necessary innovation. In this regard, it is misleading to consider financed emissions derived from transition finance as sustainability risks when this transaction could eventually contribute to GHG reduction. While some argue that financed emissions as sustainability risks should be captured in Pillar 1 or 2 frameworks, the top priority should be establishing the

appropriate methodology in quantifying these risks, taking into account the above-mentioned challenges and significant data gaps. In addition, any initiative should not jeopardize financial institutions' incentives to provide transition finance that contribute to the final goal of GHG reduction. Importantly, a successful transition would maintain the soundness of the global economy and financial system, whereas a failure would lead to the deterioration of financial stability.

Thirdly, financial disclosure on sustainability risks and market valuation will work as a practical driving force to facilitate transition process to the net-zero economy. In this regard, TCFD and ISSB are playing very significant roles. Market discipline through market valuation based on financial disclosure, including firms' commitments and strategies to address sustainability risks, will encourage firms to transform themselves. In order to enhance this process, financial authorities should focus their efforts on increasing comparability and inter-operability. Establishing appropriate financial disclosure on sustainability risks will ultimately act as a valuation mechanism that enables stakeholders to measure financial risks and the potential need for more capital held by financial institutions.

Over the last several years, the discussions on sustainability risks, as well as our understanding of various challenges to address them, have deepened. As sustainability risks have become more imminent, it is time for us to seek a more pragmatic approach.



## HIROTAKA HIDESHIMA

Counsellor on Global  
Strategy to President and  
the Board of Directors –  
The Norinchukin Bank

### Sustainability risks in the banking sector: major operational challenges

#### Implications of structural changes to the economy

As with any structural changes to the economy, regardless of whether it is due to technological advances or to policy changes, there will be those entities that will adapt better and those that will not. This would probably be true within those sectors that find the changes favourable, as well as within those sectors that find them unfavourable. Thus, the challenge for banks would be to assess whether each of their borrowers are capable of adapting to the forthcoming changes.

#### Macroeconomic implications

At the macroeconomic level, there can be debates around whether the policies towards improving sustainability will bring down the potential growth rates on a net basis, given the increase in the constraints on the supply side. There will surely be increased demand for sustainable investments, but the reduction in non-sustainable

investments may be at a similar scale. More constraints on the supply side is likely to lead to higher prices, but the impact on interest rates may be unclear with the combination of lower potential growth rate and higher prices. The impact on the exchange rate will probably depend on the impact of these changes on exports and imports, and may be different across different economies.

#### How to incorporate in risk management

How should we incorporate these elements in the risk management of banks? As is pointed out in the Basel Committee's April 2021 document "*Climate-related risk drivers and their transmission channels*", my understanding is that they should be observed through the traditional risk categories of credit, market, liquidity, operational, and reputational risks.

#### Credit risk

It can be argued that sustainability risks should already be incorporated in the internal credit decisions of banks. Banks are, and should be, making credit assessments of potential and existing borrowers taking account of any structural changes to the economy, including the need to address sustainability risks. Such assessments needs to be made at the individual entity level, and not sector level. The result of such assessments should be incorporated in the outlook of the profit and loss and then on the credit ratings of the borrowers, for example by downgrading (or potentially up-grading) the borrowers. The appropriateness of such actions should be tested with the back-testing comparing the actual default rate and the estimated probability of default for each rating grade (note: do not try to adjust individual PDs of the borrowers since this will make back-testing impossible). There may be a question of the time horizon. My view is that traditional credit risk assessment should continue to be made on the traditional one to three year time horizon, and the longer time-horizon should be dealt with in scenario analyses. Any insights gained from the longer horizon scenario analyses should be fed into the traditional credit assessment process.

#### Market and liquidity risks

As for market and liquidity risks, there is a question of whether we can move away from the tradition of basing quantitative parameters on historical observations only. There may be a case for allowing qualitative adjustments to the parameters based on the assessments of the impact of sustainability risks on the behaviour of market indices or the behaviour of

borrowers. For example, there may be a good case for assuming a higher interest rate than in the past, so there might be a need to adjust the VaR figures from that solely based on historical observations. Similarly, there may a case to assume a different drawdown rates of credit lines as borrowers adjust for the sustainability risks. One necessity may be to back these qualitative adjustments with back-testing, and adjusting those adjustments as necessary.

#### Operational and reputational risks

As for operational and reputational risks, my view is that banks should follow the Basel Committee's June 2022 document "*Principles for the effective management and supervision of climate-related financial risks*", except for the need to expand the concept from climate-related financial risks to sustainability-related financial risks in general.

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#### The current state

Are we doing enough at the moment? Probably not. There is much more that needs to be done. However, if we adopted the notion in the April 2021 paper of the BCBS to "observe through the traditional risk categories", the issue does not seem to be unsurmountable. Some people point out that the risk is too large and that we will end up facing a huge increase in capital charges. I am not sure. Whether or not the risk will increase at a huge scale is an empirical question, and we have experienced economic transformations in the past, both due to technological advances and policy changes. As long as there is clear policy of internalising the externalities, the cost of transitioning should be borne by the economy widely, and there should not be an unduly high cost placed upon the banking sector.



## JOHN MURTON

Senior Sustainability Advisor –  
Standard Chartered Bank

### Tackling sustainability risks in banking: progress and future challenges

The impact of climate change on society and the economy is not new, but is certainly accelerating. The 'physical risks' from climate change are set to materialise in an increasingly unpredictable manner going forward. As we transition to low-carbon economies, such physical risks will be accompanied by escalating 'transition risk' (the risks of stranded assets in high-carbon sectors). Both phenomena give rise to financial risks, with the result that these issues are high on the agenda of regulators as well as a top priority for the banking sector.

Banks must build up capacity to identify, monitor and manage climate-related risks for their own sake, for the stability of the financial system overall but also to be able to provide financing to the transition to a Net-Zero economy. At Standard Chartered, we have been working on embedding climate risk into our day-to-day-operations since 2019, including our governance, risk management framework, and our business strategy. This includes, for instance, the individual assessment of our corporate client sensitivity to climate-related risks and their state of

readiness for the transition, which is then aggregated to identify portfolio hotspots and inform decision making.

Standard Chartered has committed to mobilising USD 300bn of sustainable and transition finance by 2030. This helps our clients to manage their own climate-related risk while concurrently managing our own. We work on achieving this by dramatically increasing climate and transition finance available to clients, launching new products, and withdrawing from specific activities and assets.

As we make this journey, it continues to be difficult to measure and identify sustainability risks. The lack of data – and geographical variations in its availability – coupled with the difficulty of isolating physical and transition risks presents a range of challenges. Technical expertise in this area is still limited. Combining long-term macro-economic trends with climate impact projections (which will be felt first through extreme weather events) remains an inexact science. Assessing transition risk, even more so.

Against this background, the growing body of mandatory sustainability related disclosures regimes will act as an important enabler. This includes for instance, the EU Corporate Sustainability Reporting Directive (CSRD) as well as Pillar 3 disclosures under the revised Capital Requirements Directive (CRD VI). The wide adoption and implementation of the International Sustainability Standards Boards' guidelines is also a positive development. Disclosures by counterparts and clients will allow financial institutions such as Standard Chartered to better assess our exposure to sustainability risks and plan our own transition strategy. It will be critical that the various disclosures regimes are interoperable and do not become a patchwork of different requirements.

**A globally coordinated approach between standard setters and supervisors is essential.**

The introduction of regulatory obligations to develop transition plans – including the EU Corporate Sustainability Due Diligence Directive (CSDDD) – will improve matters further: transition plans are a strategic tool for banks to manage and track their climate risks. At Standard Chartered, we are currently working on developing our own transition plan, which will

be instrumental for navigating the challenges and opportunities presented by climate change, and the transition to a low-carbon economy.

Whilst this improved regulatory context is hugely valuable, it is essential that standard setters coordinate their approaches in order to avoid unnecessary complexity and duplication (which might in turn risk a stagnation of financing). In this regard, we welcome the ongoing NGFS work on transition planning which will feed into the work of standard-setters to foster global adoption.

Finally, whilst such regulatory enhancements will be important, we must not lose sight of the fact that some transition risk will come from unexpected quarters and may come swiftly. Low-carbon technology such as solar panels and batteries have seen huge – 85% – price reductions over the last decade, resulting in a level of uptake and expansion thought impossible just a few years ago. Even if it's not enough to solve the climate crisis, discrete sectors of the low-carbon economy may enjoy years of explosive commercially-driven growth in a manner reminiscent of computing and mobile telephony in recent decades, with associated wealth creation and destruction. This may prove to be a headache for risk managers, but it's the sort of problem that is – in climate terms – very much better to have than not to have.