

Sustainability risks in the banking sector

The Chair stated that operational challenges have been on the agenda for a significant period. There is a broad consensus that it is urgent and that many initiatives are necessary. Financial intermediaries are key in the transition that is needed to help European economies manage. Financial intermediaries provide the funding, but by their very nature, they are there to reduce asymmetries of information, to ensure delegated monitoring and to provide liquidity.

1. Context, stakes, and challenges to address in the banking sector in order to translate macro-level sustainability visions into the micro-level

1.1 Multiple factors are at play

A Central Bank official stated that the sustainability issue is very important from three points of view. Natural disasters are taking place year after year and the risk is becoming more imminent. There are still many challenges to face, such as the data gap, uncertainty on government policies, technologies, and the market and public perceptions and geopolitical risks. It is vital to move forward, especially considering that the risk is becoming more imminent. Practicality and pragmatism are required.

A Central Bank official explained that policy coordination is needed for the aforementioned to happen. Climate related or sustainability issues are an external matter, so there needs to be policy coordination between the government and the private sector. Policy coordination among governments and private sectors or global governments might be also important. The second aspect is engagement by the government, financial sectors, financial authorities and top corporate management to the greenhouse gas intensive industry. The third aspect is transition, including the transition in finance. Good benchmarking and best practice need to be set up. Regarding regulation and supervision, a Pillar 3 approach is preferable to Pillar 1 and Pillar 2.

1.2 Uneven macro-level sustainability visions and goals

A Central Bank official noted that macro-level sustainability visions and goals sometimes differ from country to country, and sometimes even within a country between different decision makers. Nuclear power can be considered green and not green. When thinking about an international bank or a pan European bank, one country pushes it to finance nuclear power plants or nuclear energy, and another does not. Translating macro visions to micro-level decisions can also be difficult because the global needs are not necessarily the needs of the local

community. Banking products can also be a challenge, such as mortgages or commercial building loans. Agriculture is a very complex sector that was excluded from the EU taxonomy, but agriculture finance is a significant part of a universal bank.

A Central Bank official added that the regulatory requirements and tools should adjust to challenges. Supervisors and regulators do not want to put unnecessary burdens on banks. Discussion is taking place about how to enhance and facilitate competitiveness, and it is almost certain that will not happen if extra administration is put on them.

1.3 The excessive focus on climate change obscures the multiple sources of risk that are unfolding; banks are expected to drive the economy, but they should only be supporting it.

The Chair agreed that the macro issue itself is an issue. There are many variations across countries at a macro level and the immediate objectives may not be the same.

An industry representative stated that the largest operational challenge is the disproportionate attention that is attached to climate change. When thinking about risk management and when focusing on the area of credit risk, when assessing the creditworthiness of borrowers, banks should be looking at them one by one. If there is a technological shift or any type of structural shift within the economy, there will be winners and losers within sectors. Thus, labelling sectors for risk management purposes is inappropriate. No data from the past is sufficient to make that assessment, so banks will have to come up with their own qualitative assessment based on their intelligence gathering.

An industry representative noted that the largest risk might not be climate change, so geopolitical risk and other risks must be kept in perspective. The excessive emphasis on climate change is problematic, as it is causing many expectations from many people. People have expectations about who should be doing what by 2030 or by 2050, but individual borrowers might not be moving in that exact way. A one size-fits-all approach is not beneficial. Banks can support the real economy as they transition but cannot drive transition.

An industry representative highlighted that he is a member of the task force on nature related financial disclosures (TNFD), which is the nature version of the task force on climate related financial disclosures (TCFD). The disproportionate attention given to climate change means there is insufficient attention given to nature, which is a problem. The best solution is to start from the risk management and supervisory review components of Pillar 2 (not the capital add-on component), and not Pillar 3.

The Chair agreed that the financial sector is there to support those who are trying to move the economy. Expectation management is essential; different types of risk drivers will affect sensors.

1.4 The transition is driven by economic players in the various economic zones around the world; it is essential to understand underlying trends and resulting risks

An industry representative stated that climate change is important, but from a banking perspective, the physical risk of climate change is the lesser of the issues that need to be worried about. Physical risk from climate change will not manifest itself in a chronic way but in an acute one. Transition risk is the area that banks need to examine. Many banks have historically conceived of transition risk as the risk that a government might come along with a new regulation and say that things need to be done in a specific way on account of climate change. The assumption has been that the transition to a low-carbon economy will be policy driven rather than commercially led, but in the real economy the transition to a low-carbon economy is commercially driven and will happen much more swiftly than any policy-led models might imagine.

An industry representative noted that the world is past the tipping point on many technologies such as zero emission vehicles (ZEVs) and precision fermentation. Solar power is the cheapest power that has ever been known. Sinopec believes that China has passed peak oil, but the stock market valuations of many major oil companies around the world assume fairly constant cash flow over the next 20 to 30 years. The production capacity of the Chinese economy for solar panels in 2025 will reach two terawatts. If all of that year's production of solar panels is installed around the world and operates at 15% efficiency it will displace 9% of global power requirements.

An industry representative added that there will be a geography to the transition risk. Energy intensive industries will move their businesses to where power is cheapest, which will be where solar power exists. What needs to be done is to disentangle climate risk from transition risk and to look at the transition risk irrespective of the climate debate.

2. The accuracy of sustainability risk assessment and pricing in the banking sector and on financial markets remain areas of concern

2.1 In the green asset ratio (GAR) green mortgages are the predominant form of green assets, but a great deal of the data is unavailable for existing loans. The situation is worse for corporates

An industry representative stated that Deloitte recently did a benchmarking of the GAR and found that the average GAR in European banks is 2.6%, which is very low. Some Dutch banks have as high as 20%, but in central Europe the number is as low as 0.1%. Only 50% of the 66% of the balance sheet that is exempt is currently covered by the EU taxonomy. Green mortgages are the predominant form of green assets and 25% of large European banks do not have any reporting on them. The average GAR is 7% for the 75% of banks that reported green mortgages. When examining Dutch or Norwegian banks that have very high

GAR the green proportion of those mortgages tends to be above 20%.

An industry representative added that data is needed, but a great deal of the data is unavailable for existing loans. Only 20% of banks reported any green assets in corporate, with the ratio around 6%. The Corporate Sustainability Reporting Directive (CSRD) will help. The energy and automotive sectors are very strong, but transport, real estate and cement are lagging, and breakthrough technologies are needed. Data is needed, especially energy performance certificate (EPC) data.

The Chair agreed that there are limitations in the GAR, but the EBA believes there is value in the way it can help understand the differentiation across types of banks, geographies and portfolios.

2.2 It will take time to improve the information and data and refine the models, which suggests partnering with experts and developing risk mitigation approaches involving the public sector

An industry representative explained that they primarily work with banks in the Central European region. The root cause of the operational challenges is that the risk and reward profiles are unclear. The pricing of green assets is based on market conventions. There are many sophisticated models in the background and stress testing scenarios, but when it comes to business there is a convention on how many basis points the green premium is worth and it is not related to the more sophisticated approaches. The banks do not tend to have sizable green funding pools. Many banks have issued green bonds and received funding, but it is quite limited.

An industry representative highlighted that it is likely that the risk management departments in banks are wrong. There are sophisticated calculations, but they are dependent on many inputs and assumptions, and if they are slightly changed then there is a completely different answer. The solution is getting the business side roughly right, as nobody knows where the transition risk is going. More data and disclosure to refine sophisticated models is useful, but it is going to take too long. The public sector needs to intervene and help, because pricing is imperfect. Subsidised lending and blended finance are needed.

A Central Bank official stated that understanding the climate and nature risk requires knowledge from many areas of science. Since 2022, the Hungarian Central Bank has been working on an environmental, social and governance (ESG) questionnaire recommendation for banks regarding the integration of ESG risk into credit risk and modelling. Dozens of meetings have taken place with external partners such as the World Wildlife Fund (WWF), Greenpeace, universities and experts.

2.3 Some supervisors try to leverage the attractive risk profile of green long-term investments; the starting point should be enabling internal rating systems to account for environmental risks

A Central Bank official observed that supervisors tend to prefer using the stick rather than the carrot for regulatory capital. By adopting a risk-based approach, supervisors might favour entrepreneurs who focus on long-term green financing because there is a positive

correlation observed between that and the improved probability of default (PD) and loss given default (LGD). The Hungarian Central Bank has initiated a capital relief program on Pillar 2 requirements and banks have responded positively.

An industry representative stated that Pillar 2 has four principles: risk management, supervisory review, capital add on, and supervisory intervention. The starting point should be how the bank's internal rating system deals with environmental risks. The current downgrades purely due to environmental risks may be relatively few based on a company-by-company assessment. Although there may be an expectation that there should be many downgrades, the few downgrades might be appropriate given that the risk management time horizon is typically 1-2 years. As a means to cover a longer time horizon, the use of scenario analysis is useful, which can also be considered as a component of Pillar 2.

3. The challenge is to effectively integrate climate and environmental (C&E) risks into the economy beyond the banking sector

3.1 Bank managers need to familiarise themselves with the risks and opportunities associated with decarbonisation technologies and sustainability risks

A Central Bank official stated that decarbonisation technologies are an area of opportunity for institutions. In oil and gas there is the financing of renewable energy and low-carbon projects. In power generation there is carbon capture, dedicated finance for it, special purpose loans for conversion and supporting institutions in the transition towards renewables. In the automotive area there is funding investments in electric vehicles. In steel there is the financing of hydrogen electrolysis technologies. In cement there is supporting carbon capture and in aviation there are sustainable fuel components.

3.2 The role of the SSM

A Central Bank official stated that the SSM started the work in 2019 with an objective to be clear and predictable. The process has been very interactive with the institutions. In 2019 only 25% of Europe's banks had demonstrably reflected the upcoming physical risks and credit risks from climate in their supervision. The SSM published a guide in 2020. In 2021 it asked the banks to do a self assessment, and in 2022 it had conducted a thematic review and a stress test. The first milestone was for banks to have adequate materiality assessments by March 2023. The second was to integrate the climate and environmental (C&E) risks into the governance strategy and the risk management practices by the end of 2023. The third was that by the end of 2024 banks should address the risks in full alignment with the ECB's expectations. There needed to be binding decisions issued for 22 banks, which enabled assessment of periodic penalties in the case the banks did not undertake the work.

A Central Bank official added that the SSM is assessing the second interim deadline that it gave to banks to integrate the C&E risks. 2024 is a crucial year, because by the end of the year the full alignment expectation will be in place. All the tools in the supervisory toolkit will be used to move the industry in the direction of risk, primarily operational risk and credit risk. The objective is that institutions have adequate risk management in place. A standing working group is in place with the European Banking Federation to allow for a continued dialogue with the industry.

3.3 The risk assessment must be comprehensive and forward-looking

A Central Bank official agreed that there should be a focus on the transition risk, as the policy changes require management from banks. One of the main robust approaches that has been seen is an alignment assessment, which compares the projected production volumes in key economic sectors with the required rate of change to meet the climate change pathway objectives.

A Central Bank official noted that the ECB had published best practices for alignment assessments in its report called Risks from Misalignment of Banks Financing with the EU Climate Objectives. The first is that scenarios are representative, and science based. This means that they are consistent with policy objectives and pathways, especially from the Paris Agreement. The second is that they are internally consistent and that the scenarios are incorporated into the strategic process, governance process and risk management process. The third is that they are re baselined and up to date. The fourth is that they are geographically relevant and aligned with the portfolio. The fifth is that they are annually updated. Transition planning must be the cornerstone in the standard risk management practices by institutions.

An industry representative stated that supervisors should be challenging banks. The Network for Greening the Financial System (NGFS) has been helpful in coming up with a climate scenario, and the hope is that it will come up with a similar scenario for nature. There is a role for supervisors to provide banks with a benchmark in carrying out the analysis of what might happen in the future, so that that could inform banks in their assessment of the credit risk for the shorter term.

An industry representative noted that assessments need to focus on the future. Banks need to ensure they are talking to the right people and that they have the right people in their organisations. If gas and industry teams are speaking to established players like the International Energy Agency (IEA) for their projections of solar uptake, then they are going to be wrong. Risk models have to reflect that what will happen will be very different than what has been predicted.

An industry representative added that banks also need to stay abreast of business innovation. The value in the next phase of the transition to the low-carbon economy will come from the software that governs how solar panels and renewable energy are integrated into an energy grid. An understanding is needed around what innovation is taking place and what is happening behind

the meter. Banks also need to stay abreast of the interactions between sectors. 40% to 45% of global shipping is shipping hydrocarbons, and if the hydrocarbon sector is eroded by electrification, then that is going to have a knock-on effect on the shipping sector. Integration will take place.

3.4 Forward-looking holistic approaches require adequate disclosures and a structured cooperation between the public and private sectors

A Central Bank official explained that in terms of public-private partnership in Japan, the Ministry of the Environment, the Ministry of Economic Trade and Industry, the Ministry of Finance, the Japan Financial Services Authority (JFSA), the BOJ and the Japan Business Federation are working together on improving the issue, particularly on how to utilise the risk to improve productivity or potential growth. Japan is trying to improve its economy and its energy mix, utilising nuclear stations, renewables, and trying to use hydrogen to manufacture steel. Around 1,500 Japanese companies are complying with TCFD disclosures.

A Central Bank official noted that major banks and plenty of regional banks are making a clear commitment to support the sustainability finance; they established a designated function and unit led by the senior executives in charge and established a strategy to reduce greenhouse emission vis-à-vis greenhouse intensive industries. The BOJ is providing the sustainability finance operation in the market and is back financing

green sustainability lending conducted by financial institutions. The Japanese government recently started issuing the transition government bond, and the BOJ and the JFSA are working on the scenario analysis with respect to activities around the sustainability risks that started in 2021.

A Central Bank official highlighted that due to the possible negative externalities of market failures, some regulation and supervision might be necessary. A Pillar 3 approach is needed, because it is very challenging to quantify the risk of sustainability in an accountable and transparent manner, both in terms of physical risk and transition risk. Pillar 3 might be useful, but in Japan many projects are being worked on under a hybrid of the Pillar 2 and Pillar 3 approaches. In the medium to long term, it might be useful to set up some benchmarks to show a useful way to address this risk. Cooperation among the private sector and public sectors could be essential.

The Chair agreed that staying abreast of developments and being innovative is an opportunity. There are going to be coordination aspects, and it will be complicated. Tools are being used that should be flexible to combine the carrot and the stick approach. Expertise is needed. Horizons and patterns are evolving. It is also encouraging to see that data is coming in. Data can be used, but the traditional backward looking regulatory approach will not work.