Banking sustainability risks: prudential implications

1. At the heart of the current 'learning exercise' is a key question for the banking sector: how do climate risks impact prudential frameworks?

A Central Bank official explained that sustainability and environmental risks remain relevant for the financial system, as is evident from the reports of the Intergovernmental Panel on Climate Change (IPCC). In 2015, Mark Carney's speech on the relevance of climate risks for the banking sector was the starting shot for enormous developments by banks, supervisors, regulators, and market participants related to sustainability and climate. As an example, both the European Central Bank (ECB) and the Bank of England now are now conducting stress test for climate risks.

1.1 This 'learning exercise' is focused on assessing banks' progress on incorporating sustainability risks into frameworks and practices.

A Central Bank official suggested that 'learning exercise' is a key phrase in the debate. There is a question about whether the industry should be moving towards something more specific than a 'learning exercise'. The other key part of the debate is data. In this field, data is not easily found or analysed. The data is granular and difficult to understand. The Single Supervisory Mechanism (SSM) wants banks to look at the risks posed by climate change. The SSM's new test was launched last week. In September 2021 the ECB published its economy wide climate stress test and subsequently reported on how banks are adjusting their models and managing climate risk. There will also be a 2022 review on the incorporation of climate and environmental risks into banks' practices. The SSM's new test will be 'gentle' for banks because it looks at qualitative issues and does not include capital requirements. The industry as a whole must think about whether the banking industry should remain in a 'learning exercises' or whether the public authorities can push banks further here. While the pandemic and other global issues have created more awareness of sustainability risks, the banking industry needs to address them more proactively.

1.2 The existence of such 'learning exercises' is due to the many new challenges posed by sustainability risks

An industry representative noted that the banking industry faces a challenge posed by the fact that climate related risks are long term while banks' investment horizon and balance sheet maturity is much more short term. It is difficult to adjust asset structure given the high level of uncertainty about technology, climate, and policy. Additionally, smaller subsidiaries of large financial groups are limited by local resources and capabilities. To a certain extent, these entities must rely on their parent's environmental, social and governance (ESG) initiatives. As an example, if the parent selects the long term stress scenario and the group entities use the scenario, this can mean that local specificities are not properly captured. For groups headquartered outside the EU, there is also a challenge on the timing and deadline. Most banks prioritise short term actions with higher impacts, such as risk identification and governance. There is also a problem around data. It is difficult to assess borrowers or counterparties in terms of performance on climate related risk management when there is no readily available, comprehensive and comparative data.

1.3 Defining and accessing appropriate and quality data is an evolutionary process

A Central Bank official highlighted the importance of starting the ESG journey before 'perfect data' is available. The process of developing good quality data was always likely to be slow. Another industry representative agreed, adding that it is important to avoid greenwashing. If a bank is financing a business which is buying more energy efficient machines, it is essential to understand the carbon footprint of these machines and determine whether the purchase could increase carbon emissions. Indeed, bankers are not climate specialists. Banks need people with the right skills.

1.4 Despite awareness in the banking sector, most notably in the EU, the 'learning exercise' remains partial and uneven, and only the very first steps have been taken

A regulator agreed that there is a sense of urgency around sustainability. In May 2021, the European Banking Authority (EBA) published an assessment of the alignment of banks to the taxonomy and some sensitivity analysis. This report had four key conclusions. First, banks are clearly extremely committed. Banks volunteered to participate in the EBA's exercise. There were 29 banks from 10 countries, which is over 50% of banking assets. Secondly, there is a scarcity of data. Thirdly, while there is meaningful information for portfolios such as large corporates, the data is heterogeneous. Banks have developed their own datasets in their own ways over time. Finally, there is a need to steer expectations. The transition risk in some portfolios can be extremely significant. This must be organised collectively in an orderly manner. These exercises will help to steer banks in the right direction and manage any side effects.

Noting that his comments would focus on S&P's interaction with banks in the rating process, an industry speaker suggested there were two key elements to managing climate risk for banks. While there has been significant progress, this is only the beginning of a long journey. The ECB also recently made clear that, while there has been progress, it has been too little and too slow. The industry accepted the goal to be net zero by 2050, but there is a lack of speed. There is a lack of focus on the intermediary steps to reach this goal. On a positive note, banks are increasingly aware of the correlation between environmental risk and financial risk. The European banks are advanced in this area, though US banks are catching up quickly. This trend is also evident in Asian countries such as Hong Kong or Korea. Sustainability risk is a key priority for many CEOs and board members. The sustainability expertise of board members has been improving steadily. Remuneration is increasingly being indexed or partly related to sustainability achievement, which creates a strong incentive to make progress.

The industry speaker highlighted the fact that exclusion policies have become very common in the industry. The integration of sustainability risk in risk management and strategy is not uniform across banks' business lines. The large banks have made the most progress, because they started earlier, and they have more expertise. They have been able to attract talent because they have the financial means to do so. This will be a challenge for smaller banks. In terms of the debate between exclusion and engagement, there has been less engagement. Exclusion is easier, but it is probably not the only needed strategy as it can result in sustainability risk simply moving to another lender. There are areas for improvement, however. For example, very little attention has been given to issues such as biodiversity or water scarcity and pollution. When banks make commitments, they tend to be relatively general. There is a lack of key performance indicators (KPIs) or key risk indicators (KRIs). Scenario analyses and stress testing are also relatively rare. They are done when regulators ask for them, but the banks themselves struggle to do them. The regulators can play a key role in guiding banks. It is interesting to hear that banks are keen to conduct stress testing. There is also a lack of high level assumptions. The work done by the regulators and the Network for Greening the Financial System (NGFS) can be useful for banks because it marks the beginning of consistency on what these high level assumptions might be.

1.5 Sustainability risk has still not been incorporated into analyses of banks' creditworthiness

A Central Bank official queried whether sustainability risks affect firms' credit ratings. If there are true prudential risks, it would be interesting to understand how these might affect ratings in the financial sector and the non financial sector. An industry speaker suggested that this is a huge challenge for all players in the financial sector, including ratings agencies. Ratings agencies have also had to build expertise. S&P created a sustainable finance team, which has 60 analysts dedicated to ESG. S&P has published ESG criteria, and this has been embedded fully in its criteria. Until now, there has been a greater impact on corporates. For instance, last year S&P downgraded a number of major oil companies due to changes in public policy and investor pressure. The impact of climate risk on banks has been limited so far because banks' business models are diverse and because these risks are long term. For banks, it is difficult to predict how and when the risks will materialise.

1.6 There will be a competitive advantage for 'first mover' institutions that integrate sustainability risks into their business models, governance, and credit risk management

A Central Bank official explained that the UK supervisors are not in a 'learning exercise' on sustainability risks. Policies on climate risk came into force on 1 January 2022 and firms are expected to meet them. The firms that do well on this will gain competitive advantage because the regulators will judge other firms with reference to these firms' practices. A Central Bank official queried whether UK regulators would go into their toolkit and use 'tough' measures. The Central Bank official confirmed this, suggesting that sustainability risk is like any other aspect of supervision. If firms do nothing to address supervisory expectations, there will be consequences. Sustainability risk is no more complex than some of regulators' other tasks, although the capital element is certainly tricky.

1.7 Additionally, there is a need to incorporate stress test results in capital requirements

The scenario exercise or stress test being run across the UK system currently is indeed more of a 'learning exercise', however. The UK authorities have been clear that they will not be setting capital requirements as a result of this exercise, which is relevant to the capital debate.

2. Policy initiatives required to address sustainability risk in the banking sector globally

2.1 Policy actions must preserve banks' soundness and define banks' role in the transition

A Central Bank official queried whether the banking sector has the right mix of government policies and private sector measures, noting that it might be possible for banks to compensate if governments are slow on carbon pricing, the responsibility cannot simply be transferred to the banks. A regulator agreed that the policy discussion should be framed around the distribution of responsibilities. The banking sector has a role to play in facilitating the huge relocation of resources required by an orderly transition.

2.2 Defining a sustainability-related risk profile should be left to the management of financial firms; regulators should focus on banks' risk assessment and management practices

A member of the audience suggested that there could be remuneration for good sustainability performance and queried whether banks should be outspoken on sacrificing returns in order to achieve sustainability objectives. A Central Bank official emphasised the importance of regulators not overstepping their boundaries. There are legitimately different choices for private institutions to make about whether to sacrifice short term earnings for other gains. Regulators should not police that. Regulators should expect firms to 'grip' these issues, however. A regulator suggested that remuneration for good sustainability performance would change the balance of risk and return. Banks could have lower returns if they are noticing and properly addressing the risks related to climate developments.

2.3 The specificities of sustainability risk require supervisors to force banks to adapt their long-term lending, investment, and risk management policies using Pillar 2 measures and stress testing

A regulator explained that physical and transition risk will affect the safety and soundness of financial institutions and could eventually have implications for financial stability more generally. This means there is a clear case for adjusting the regulatory framework, without stretching the mandate of regulation, to ensure that banks have a climate related risk management framework which is consistent with their risk appetite, risk profile and operating environment. Due to the long-time horizons and the uncertainty around the materialisation of climate related risks, standard instruments, particularly Pillar 1 type instruments, are not suitable for addressing these risks. The Pillar 2 framework under the Basel principles allows for capital and non capital instruments; this could be effective in ensuring banks assess and manage climate related financial risks. Certainly, much of what is done on Pillar 2 could be based on a climate stress test. Supervisors could use these tools to increase banks' awareness of deficiencies in the way they manage climate related financial risks, which could be used to produce management actions for banks. If it is necessary to increase loss absorption capacity, it is possible to introduce capital add ons under Pillar 2. The flexibility of Pillar 2 will be helpful in properly addressing these risks, but this could generate level playing field issues. There should be general guidance on the use of Pillar 2 to address climate related financial risks, which could develop the options being considered by the Basel Committee.

Another regulator noted that this is one of the EBA's priorities. The EBA wants to embed these elements in its regulatory risk analysis and risk assessment reports. It is imperative to ensure that regulators have the right information, however. The EBA is also working on risk management. It has clarified its guidelines on including sustainability risks and risk drivers in risk appetites, risk management practices, remediation schemes and stress testing approaches. In terms of international coordination, the European framework is very similar to what was discussed and developed in Basel. The EBA is also working on the prudential treatment and will publish a discussion paper in 2022 with a view to producing a more advanced report in 2023, as requested by the Commission. The EBA is working with the Basel Committee on this, but there is a need for data. Banks and supervisors will need to put considerable effort into this.

2.4 The backbone of sustainability risk management is Pillar 3, which will involve disclosures

A Central Bank official noted that the Basel Committee is working hard on producing global standards. A regulator described how the EBA is working on disclosure, which is Pillar 3, risk management, which may come into Pillar 2, and Pillar 1. Progress must be made on disclosure, which is the backbone of this issue. The EBA has published a package with a number of proposals to help banks to structure information for market participants. The green asset ratio (GAR) is one useful measure, but it is important not to have one single indicator but a combination of things which can help people understand companies' balance sheets.

2.5 Pillar 1 challenges: data, a lack of analytical tools and the long-term nature of sustainability risk

A Central Bank official noted that the EBA's consultation on its Pillar 1 proposals is yet to start. A regulator stated that the EBA will issue something on this in the first half of 2022, adding that not much more could be currently said about the subject. The Commission, however, has high hopes that the consultation will set the stage somewhat more precisely.

A Central Bank official outlined the Bank of England's clear philosophy that it is not a good idea to use the bank capital framework to drive the transition. It will be both bad for the bank capital framework and ineffective. The evidence on the effect of the SME discount factor, for example, strongly supports this. The framework should simply capture the risks from climate change. It is hard to determine whether the risks are in fact captured due to capability gaps and framework gaps. These capability gaps include data, a lack of channels for macro effects to move into bank capital and a lack of analytical tools. Secondly, there are also framework gaps. Much of the Pillar 1 framework happens on a one year look forward basis, which immediately demonstrates why a large amount of climate risk cannot be captured. The Central Bank official asked the other panellists whether the capital requirements for the banking system would be increased if the framework did not capture these risks properly. This is the 'elephant in the room'. Alternatively, and very unfashionably, climate risk might be more of a pay as you go drag on earnings.

2.6 The inclusion of a green supporting factor within the prudential framework raises difficulties, because a green asset is not necessarily a safe asset; additionally, bank solvency regulation is not the only policy tool to addressing transition challenges

A member of the audience considered it interesting that the supervisor and regulator on the panel supported a green supporting or brown penalising factor. In the political arena, this is a difficult issue. A regulator emphasised the importance of being evidence based. Something that is green may also become a high risk over time. There could be incentives down the road, but it is difficult to do something that would distort the pricing of the risk ex ante. Another regulator explained that the green supporting factor would break the link between risk and capital requirements, which can hardly be positive in terms of financial stability. Conceptually speaking, it may well be counterproductive. The first regulator stated that, when stakeholders realise the potential transition risk impact on banks' balance sheets and the economy at large, they might consider incentives of this kind. However, this could easily make the transition more disorderly than orderly.

A Central Bank official asked the panellists to comment on whether there is currently the right balance between government policies and what is expected from banks and whether things are progressing at the right pace. A Central Bank official suggested that this is an awkward topic because it sometimes feels like regulators are trying to fill gaps that other players will eventually need to address. Another Central Bank official agreed on the need to move on a similar path on sustainability risk issues. What central banks can do also depends on the choices of governments.

3. Seeking consistency and regional specificity can smooth corporate financing in the transition

An industry speaker stated that the regulatory and supervisory framework in Europe is more advanced than in any other region. In Japan, the Japanese regulator is designing a new disclosure framework and supervisory framework. The major Japanese banks have already started carbon neutrality initiatives and are aligning with the Paris Agreement by integrating climate risk into their risk management and governance frameworks. They are also making disclosures in accordance with the Task Force on Climate related Financial Disclosures (TCFD) and engaging with clients on the green transformation. From the international bank perspective, the pathway to carbon neutrality differs by region and country, but the initiatives for carbon neutrality by global corporates should be done on a global basis because capital flows globally. There is indeed a lack of consistency. On ESG ratings, for example, many rating agencies are providing ESG ratings to corporates, but the scores given by each ratings agency are completely different. Given these factors, there is a need for international harmonisation of regulation. However, it is important to balance international standards with local standards. In that respect, the Basel Capital Accord is a useful example of an international common standard which also has national discretion.

Additionally, it is essential to avoid creating funding risk in the transition. In order for corporates to transform their businesses, they will need an unprecedented amount of investment in renewable energy. However, they also have to maintain credit quality; they have to continue to access funding. The capital should flow to green, but there is a risk that corporates will not be able to raise funds appropriately due to this short term ism. Ensuring that liquidity is appropriately provided to enable corporates to transform their businesses should be monitored locally as well as globally.