Sustainability risk in the EU banking sector

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An official explained that sustainability risk in the EU banking sector is a key topic for both regulators and market participants. The Basel Committee on Banking Supervision (BCBS) is working on all aspects of climate related financial risks, including regulation, supervision, and disclosure.

2. The lessons to learn from recent regulatory reports

2.1 The ECB's thematic assessment: banks must assess the materiality of sustainability risk and disclosure exposures and conduct stress testing

A Central Bank official outlined the action being taken by the European Central Bank (ECB) on climate risk. In 2020, the ECB issued guidelines on its supervisory expectations around climate and environmental risk. This was followed up by a bank self assessment. Following discussions with the ECB, the banks created action plans for how to adhere to the ECB's plan. The ECB conducted follow ups on disclosure in 2021 and 2022 and a thematic assessment. Currently, a thematic assessment is taking place on different topics related to the ECB's supervisory expectations. The ECB has also published the results of the first stress test on climate risk. 90% of banks report that they are working with the ECB's supervisory expectations and have a plan in place. However, some banks still have not assessed the materiality of their climate risk or customer risk, and there is much more to do on exposures and disclosure practices. 80% of banks under ECB supervision claim to have a plan to address climate risk and aim to be able to operationalise these plans by the end of 2023.

2.2 Lessons learned from the stress tests conducted by the Japanese Financial Services Agency (JFSA) and the Bank of Japan

A regulator advised that, with the Bank of Japan, the JFSA has conducted a pilot scenario analysis. The purpose of this exercise was not to evaluate capital adequacy but to deepen banks' understanding and create the basis for a discussion between supervisors and banks. The estimated increase in banks' costs due to transition and physical risks was considerably lower than their average net income. However, it is not enough for banks to be able to absorb the loss of existing portfolios; the sustainability of earnings is essential to the long term resilience of the business model. Banks need to take more dynamic approaches in risk management and consider the medium to long term impact of managerial decisions, changes in business strategy and changes in clients' business models.

2.3 European Banking Authority (EBA) priorities: data disclosure, supervisory practices, the prudential treatment of climate risk, stress testing and risk assessment

A regulator considered that discussions about sustainability often focus on climate, but sustainability is a much broader topic. An official noted that the BCBS is working on applying its climate work in a broader way. Another official suggested that the ECB's stress test proved there is more to do on issues such as physical risk and biodiversity.

A regulator advised that the EBA's priorities are: data disclosure; supervisory practices, the prudential treatment of climate risk; and stress testing and risk assessment. On data disclosure, the EBA has taken a sequential approach. Earlier this year, the EBA published Implementing Technical Standards (ITS) on Pillar 3 disclosures for banks. On supervisory practices, the EBA published a report on enhancing governance and risk governance practices within banks. On stress tests, the EBA is working with the European Supervisory Agencies (ESAs) and the European Systemic Risk Board (ESRB) on a risk assessment to be completed between 2023 and 2024. The EBA is also working on guidelines for institutions and supervisors on climate stress tests, which should be published next year.

2.4 Determining the prudential treatment of climate risk poses several unusual challenges, demonstrating the importance of stress testing

A regulator explained that in March 2022 the EBA published for consultation an early paper about the focus on Pillar 1, which contains two key messages. First, by definition the prudential approach to any risk should be risk based. Climate is a risk, which means it should be risk based. Secondly, double counting must be avoided. The three key areas of concern are the forward looking nature of climate risk, the possibility of additional climate related concentration risk not captured by the current framework and the long time horizon of climate risk.

Another regulator agreed that the key features of climate related risk are the long-term horizon, the uncertainty and the forward looking nature. While the typical time horizon of risk management and capital planning is two to three years, climate related risks will materialise over a much longer horizon.

2.5 The outcomes of stress testing processes depend on analytical models and assumptions

A regulator explained that the JFSA's stress testing has revealed that the estimated results of these tests depend not only on banks' analytical models and selection of variables but on several additional assumptions. There is a lack of information and a data problem, but this is compounded by the uncertainty inherent in assumptions about the evolution of businesses and technologies in specific sectors, whether and how clients' business models will be transformed to meet the climate challenge and the extent to which clients will require finance to transform their businesses. On 12 July the JFSA published supervisory guidance on climate related risk management focusing on client engagement. The resilience of banks depends on how corporate clients respond to climate change. Risk management and client engagement are two sides of the same coin. Enhancing the opportunities for banks and contributing to the transition to net zero should go together.

3. Despite uneven levels of preparation, EU banks are enhancing their contribution to the transition while mitigating their own risks

3.1 Sustainability risk and financing the transition have become central to EU banks' strategy

An industry representative reminded that banks are increasingly deeply mobilized on ESG risk management. Work is still in progress, but efforts and results are becoming more and more concrete. The situation also varies between banks, where EU banks are the frontrunners and leaders on the global sustainability journey. As such, several EU banks have been acting on sustainability risks for a long time and have capitalized on the ECB's guidelines and the EU's regulatory pressure to deliver advanced ESG risk management tools and processes. Importantly, ESG is no longer a topic reserved for a few specialists, but a business imperative and a risk management imperative. From a business point of view, banks are aligned around a sense of purpose and urgency, with ESG at the heart of their strategy and commitments. From a risk management point of view, EU banks are working on including ESG risks end-to-end, in credit analysis, rating, stress testing, and risk appetite.

3.2 Sustainability is now a key element of banks' governance and risk management; banks are designing the trajectories for aligning their portfolios in order to contribute to the transition

An industry representative emphasised that Société Générale has strengthened its governance. First, sustainability is discussed by the general management and is embedded in all of Société Générale's risk and business committees. Second, Société Générale's management incentives include a significant ESG component. Third, Société Générale has operationalised sustainability by launching a Group-wide programme called ESG by Design, which incorporates ESG end-to-end from client onboarding to risk management to products.

An official explained that the Italian Ministry of Economy and Finance is looking at whether the financial sector is playing its part in supporting the green transition. Sustainability is not only relevant for the banking sector. The private and public capital markets also play a fundamental and complementary role to the banking sector in supporting the transition.

3.3 Data availability, data comparability and the fragmentation of related standards

An industry representative suggested that banks need to address several important knowledge gaps. Bankers need to be very knowledgeable about industrial challenges. Notably, there are issues around data availability and data quality, and there is also considerable regional fragmentation of related standards and regulations. For global banks with global clients, this is a challenge. It is therefore important to take an industry by industry approach because there is a need to understand what is at stake from a transition and technological point of view and how business models are shifting.

An official advised that data needs to be complete, verifiable, and comparable. When Italy had the G20 leadership, Italian policymakers sought to build a consistent framework of reporting disclosure, scoring methodologies, rating methodologies and labels across the globe. A regional approach is being taken by the European Financial Reporting Advisory Group (EFRAG), and the International Sustainability Standards Board (ISSB) is leading a global initiative. There should be a common global baseline, which will enable regional approaches to be even more ambitious. Having more information that is not comparable will not create market efficiency.

3.4 Enabling small and medium sized enterprises (SMEs) to provide sustainability data will require more than legislation

An official emphasised the importance of SMEs in the discussion on climate risk. Europe's 23 million SMEs represent the backbone of the real economy. The data reporting obligations cover a small fraction of them. This also applies to the Corporate Sustainability Reporting Directive (CSRD). These SMEs cannot bear the cost of producing this information. They do not know what they must produce, and they do not know how to produce it. This might not require legislation; it could be addressed through industry led initiatives and financial education. If Europe's SMEs are notable to provide the information, banks will have to stop lending to them. The scope of ESAP should go beyond the 50,000 firms covered by the CSRD. The European financial industry needs to continue to work on data quality and data production, and there is also a need for a taxonomy that incentivises brown firms to become greener.

4. Quality, comparability, and reliability: benefits from the CSRD

An industry speaker stated that the CSRD would improve data quality by creating standardised information. Everyone in Europe will apply the same regulations, which means they will be speaking the same language. Common reporting standards are currently being written by EFRAG, and the third party review of information will improve reliability.

4.1 The CSRD will be progressively implemented and improve non-financial reporting, but requires some convergence between standard setters

The industry speaker advised that the journey will be long. The CSRD will be implemented progressively from 2024 until 2028, but it will not cover some SMEs in the EU and non EU entities. Therefore, convergence between standards setters is important. Currently, there are many differences between draft European regulation (ESRS) and the ISSB's proposals, for instance. It is not necessary for every jurisdiction to have the same reporting standards but having a common backbone would improve comparability and reliability. Europe has taken a different path to some of the international standards setters. For instance, there is no convergence on the concept of double materiality. Europe is insisting on the importance of considering the impact of climate risk on financial key performance indicators (KPIs) and the impact of entities on the climate. This is not clearly stated in the ISSB framework, which is more focused on investors.

5. Global and EU priorities to make progress on sustainability risk mitigation in the banking sector

An official noted that data is a big issue. The more data can be standardised across jurisdictions, the better. The EU is leading in this area, but there is a high degree of variation even between EU banks.

5.1 Sharing best practices, building common tools, and leveraging market discipline

A Central Bank official emphasised that this is an important topic for society at large. The ECB is trying to push the banks, but this must happen holistically. There is a need to cooperate with global fora to ensure there is a joint view of cross border banks. As always, Europe is ahead in some respects and behind in others. Data is one problem, but there are also other important challenges. Some banks have made very good efforts, and the wider financial industry can learn from them. The supervisors can use their example to show that it is possible to be better and to demonstrate that it is possible to disclose more information to the market.

An industry representative suggested that this issue should be looked at in terms of business and strategy. Some European banks have paved the way because they lead on energy financing and project financing. For example, Société Générale is one of several large European banks that have been financing renewables for 20 years. These banks have identified the need for transition due to their sectoral focus, their business focus and their expertise on project finance and export finance. Regarding capital markets as well, EU investment banks are the frontrunners in designing green and sustainability bonds and incentivising clients to embark on the sustainable journey. To complement these initiatives, as the Capital Markets Union will move forward, ESAP will be an important tool to enable all banks to have access to sustainability information without engaging large and redundant resources for data collection.

5.2 Stress testing will continue to be the yardstick and catalyst of progress in the banking sector

A Central Bank official noted that the ECB's stress testing was not the usual number crunching; it was about qualitative information, governance and risk management and it looked at how well banks are able to calculate their exposures under stressed circumstances. These stress tests help regulators formulate and prioritise the next steps on climate and sustainability risk. The goal is to ensure that climate and sustainability risk is part of the normal supervisory cycle.

An industry representative agreed that stress testing has been an important learning exercise for banks and supervisors, but there are challenges around the quality of data and the assessment of the credibility of certain transition paths. There are also questions regarding how climate risk can be modelled and how a forward looking view could be considered when other statistical measures are backward looking.

5.2.1 Top down stress testing should be complemented by other bottom up approaches

An industry speaker suggested that the stress testing exercise made all stakeholders speak the same language, which accelerated the ongoing work on measurement methodologies and data collection. However, stress testing should be supplemented by bottom up corporate by corporate and collateral by collateral analyses.

5.2.2 Stress testing outcomes should eventually be reflected in financial statements

The industry speaker stated that stress testing is also important for Financial Statements. At some point, institutions' financial statements should be linked to these analyses. If climate risk is a key driver of credit risk, market risk or operational risk, it should be reflected in financial statements. The current framework of IFRS 9 could incorporate this in the measurement of expected credit losses.

5.3 Defining sustainability-related capital requirements will require forward looking risk assessments and new approaches to regulatory capital that enable banks to continue financing the transition

A regulator considered that the real challenge with environmental risk is how to assess risk in a forward looking way. The regulatory framework for capital is based on methodologies that are backward looking and statistically based. In that context, stress testing helps supervisors and market participants think in a forward looking way. However, this kind of risk analysis focuses on exceptional scenarios rather than the central scenario. There is a need to enable forward looking analysis under the central scenario.

An industry representative emphasised that further capital requirements should not be imposed on banks, as banks need sufficient financial power to finance the economy and its transitions (e.g., green and digital transitions, higher interest rates etc.).

5.4 An iterative improvement of data quality and availability

An official noted that there is a lack of historical data and high quality data. The sequential approach followed so far is beneficial. Eventually, the time will come to shift from Pillar 3 to Pillar 2 and from Pillar 2 to Pillar 1. Data is the most important task, and the ESAP initiative is key to this. This is the link between the Capital Markets Union (CMU), the digital transformation and the shift to sustainability. ESAP will help banks get the right information and help SMEs to produce information in a less costly way.

5.5 Policy makers will have to devise possible transition pathways alongside sustainability targets

An official highlighted the substantial uncertainty in these assessments. Climate risk is better understood than other ESG risks, but there is a question about how translatable the work on climate is. A regulator considered the work to be translatable at an aggregate level. The challenge is how to sequence and process the change. The presence of clear targets has made the biggest difference on the climate transition. Clear targets help identify the right way to go. In some of the environmental and social aspects, the targets are not so well defined. For instance, the financial industry has been pushing on diversity issues such as the pay gap because there is a specific target.

5.6 Setting appropriate, progressive, and proportionate ambitions will help address the wider set of ESG challenges beyond climate related risk

Responding to a question, a regulator stated that it is conceptually possible to extend the work on climate to other areas. For climate related risk, however, there are clear KPIs such as emissions. As other areas lack specific KPIs, in practice this will be very difficult.

An industry representative advised that the Taskforce on Nature related Financial Disclosures (TNFD) has 3,000 risk metrics, which shows that frameworks other than climate-risk are still in their infancy. The entire industry is mobilised, but discussions should remain pragmatic. If banks seek data on ESG risks when data is not available at the client level, more noise will be created at the cost of focusing on what matters. The priority is therefore to find the correct means to facilitate and fund the transition as it will take a significant time for clients to align. Optimistically, climate is a topic which has eliminated the silos between policymakers, governments, banks, and industry players. It has led to a constructive and fruitful dialogue, which has enabled substantial acceleration of sustainable initiatives in recent years.