SUSTAINABILITY RISKS IN THE BANKING SECTOR

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C&E risk management: work in progress

Since the Paris Agreement in 2015 the concern for climate change has reach another dimension. The agreement covers climate change mitigation, adaptation, and finance, and stablished a new goal, "to keep the rise of global temperature well below 2° Centigrade, and preferably limit the increase to 1.5° C.

As all we know, climate change has a global dimension and therefore should be addressed globally and in a coordinated manner. Europe is leading this process from the beginning. In this vein, from one hand the European Commission has reach the agreement of climate neutrality by 2050, meaning net zero greenhouse gas emissions for EU countries as a whole. On the other hand, European Central Banks, Supervisors and other international institutions, as BIS or FSB, as part of the Network for Greening the Financial System (NGFS), are working together to build common criteria regarding this issue.

The EU Taxonomy is a clear example, since some countries are taken this as inspiration in order to develop their own taxonomy.

Early supervisory assessments in Banks' management of C&E risks, before 2020, suggested that these risks were not considered relevant for a large number of institutions. Trying to address this situation, in late 2020, both, EBC published a Guide on climate-related and environmental risks.

The ECB guide sets out 13 supervisory expectations for how banks should integrate these risks into their business strategy, governance and risk management as well as disclosure expectations. At the same time, the BoS published 8 supervisory expectations for LSIs.

After publishing its supervisory expectations, the ECB has conducted several supervisory exercises on banks' approaches to managing and control these risks. First, in 2021, a bank self-assessment was conducted and analyzed, and in 2022 a climate stress test, a thematic review on C&E risks and some on-site inspections were carried out directly by the supervisors.

Even if we have seen relevant progress, institutions still need to work hard.

In late 2022, as a result of the thematic review and the stress test, the ECB published a compendium of good practices observed in some banks, regardless its size or business model.

The thematic review concluded that, even if 85% of banks already have in place at least basic practices in most areas, they are still lacking more sophisticated methodologies and granular information on C&E risks. Additionally, a supervisory concern related to execution capabilities of most banks was shown. As a result, the ECB has established institution-specific and progressive deadlines for achieving full alignment with its expectations by the end of 2024.

Additionally, the ECB is including bank-specific climate qualitative requirements on more than 30 banks in its annual supervisory assessment (SREP). Furthermore, a review of banks' disclosures is performed every year.

In 2023, and in the upcoming years, the treatment of C&E risk will remain as one of the main supervisory priorities. As a consequence, the supervisor will continue working hard to make sure that C&E risks are fully integrated with a holistic approach in the regular institutions' risks management processes and business decisions, with targeted deep dives and on-site inspections. Compliance with upcoming disclosure requirements will be also closely assessed.

In line with the ECB roadmap, National Authorities will continue working in the same direction, in order to assure the same treatment for LSI.

As regards to the prudential regulatory framework both, BIS and EBA, are working to find the proper way to integrate C&E risks under Pillar 1 requirements bearing in mind the risk-based approach. In this regard, the main challenges are the lack of historical data in terms of risk differential between exposures (i.e. "green" vs "brown") and proper methodologies to quantify these risks, closely linked with the distinctive characteristics of C&E risks such as its materialization in longer time horizons and so on. Therefore, regulators have started by incorporating these risks into Pillar 3 (i.e. ESG disclosure requirements in the EU recently entered into force) and Pillar 2 (supervisory process).

It is also worth mentioning the recent (2021) formation of the International Sustainability Standards Board. The ISSB is developing standards that will result in a global baseline of sustainability disclosures focused on the needs of investors and the financial markets. In this regard, I would highlight the Corporate Sustainability Reporting Directive, published in December 2022, according to which institutions will disclose very detailed information on sustainability risks following the standards currently being developed by EFRAG.

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Fostering banks' preparedness for the green transition

In a previous contribution for this magazine, I outlined the many efforts made by the ECB in recent years to include climate-related and environmental (C&E) risks as part of its ongoing supervision[1]. I would now like to take stock of the work that we have done in recent months to foster banks' preparedness for the green transition, and to outline the main deliverables we expect on this front going forward.

The conclusion of our thematic review on C&E risks has been a key milestone in this regard, because it has allowed our supervisors to assess the extent to which banks adequately identify and manage climate risks as well as environmental risks such as biodiversity loss. The review, the results of which were published in November 2022[2], also looked into banks' risk strategies and their governance and risk management processes in the C&E domain.

Overall, the results have been mixed. On the plus side, banks have made meaningful progress in accounting for and addressing C&E risks, acknowledging the materiality of such risks in their portfolios and making progress in building up their risk management frameworks and processes. However, the results also showed that, although the bulk of our supervised banks have in place at least basic practices in most areas, they still lack more sophisticated methodologies and granular information on C&E risks. This aspect is critical if banks are to get a firm grip on the C&E risks they actually face. The review concluded that banks therefore continue to significantly underestimate the breadth and magnitude of C&E risks and noted that almost all banks have blind spots in identifying these risks, including in physical risks related to climate change and the management of broader environmental risks beyond climate. Moreover, we also found that banks have yet to address C&E risks in a sufficiently strategic manner, with management boards rarely initiating actions that result in changes to either the strategic direction or to meaningful risk limits.

In its role as prudential supervisor, the ECB has made it clear that it is not in the business of telling banks how green their lending policies ought to be[3]. However, it has also underlined that failing to take into account the transition towards a more sustainable economy would be incompatible with sound risk management. This is why we are insisting that the banks under our supervision manage C&E risks in the future in the same way as they would now manage any other material risk.

Failing to take into account the transition towards a more sustainable economy would be incompatible with sound risk management by banks.

With this goal in mind, the ECB has now set bank-specific deadlines for achieving full alignment with its supervisory expectations in the C&E domain, as laid out in the Guide it published in 2020[4]. We are mindful that, important as it may be, this process can also be challenging for banks, which is why we have set staggered deadlines. We expect banks to already have in place an adequate categorisation of C&E risks and to have conducted a full assessment of their impact on their activities, in line with our deadline for the end of March 2023. Looking ahead, we expect banks to include C&E risks in their governance, strategy and risk management by the end of 2023, and to meet all remaining supervisory expectations on C&E risks by the end of 2024, respectively.

Moreover, in order to facilitate the supervisory convergence process, we have published a compendium of good practices among banks derived from our thematic review[5], for example as regards the integration of C&E risks into the work of the management body or the use of planning tools aimed at managing the risks of the transition, respectively. This compendium should not be seen as a "one-size-fits-all" path towards meeting of our supervisory expectations in the management of C&E risks, but rather as a demonstration of the practical way in which some banks have tackled implementation challenges in order to achieve rapid progress in certain areas.

[1] See "Climate risks for banks – the supervisory perspective", article by Kerstin af Jochnick, Member of the Supervisory Board of the ECB, for Eurofi Magazine, 7 September 2022.
[2] See "Walking the talk: Banks gearing up to manage risks from climate change and environmental degradation. Results of the 2022 thematic review on climate-related and environmental risks", ECB, November 2022.
[3] See "Urgent and vitally important: 2023 as a key milestone in stepping up the management of climate and environmental risks", speech by Frank Elderson, Member of the Executive Board of the ECB and Vice-Chair of the Supervisory Board of the ECB, at the Foreign Bankers' Association (FBA) 30th anniversary, 27 March 2023.
[4] See "Guide on climate-related and environmental risks: supervisory expectations relating to risk management and disclosure", ECB, November 2020.
[5] See "Good practices for climate related and environmental risk management: observations from the 2022 thematic review", ECB, November 2022.

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Enabling banks to finance the real transition

At Nordea, we aim to embed sustainability at our core. We are committed to reaching net-zero carbon emissions by 2050 and are well on our way towards an ambitious target to reduce absolute emissions from our lending and investment portfolios by 40-50% as soon as 2030. We have also set several sector-specific climate targets as well as sustainable financing and investing goals.

As a bank, we have a unique opportunity to facilitate our clients' transition towards a more sustainable and net-zero future. In order to drive meaningful change, we must be able to finance companies that are working to change their business models, including in carbon-intensive industries, and there must be a recognition that this takes time and effort.

Regulation that is too rigid or short-sighted risks being counterproductive, as it could limit banks' ability to help clients transition to a more sustainable future. Such a client selection approach would be counter to the European Banking Authority's guidance and would achieve very little beyond moving financing to other financial services providers that may not be as committed to instituting real change.

Nordea's commitment to facilitate real change is thus based on partnering with our clients according to their transition needs, while at the same time taking proactive steps to mitigate ESG-related risks. Achieving that objective requires a policy environment that reflects the complexity involved.

Policymakers and supervisors have set an agenda that will introduce a number of changes quite quickly. In our view, it will be key to ensure that the policy measures help us achieve our stated aim – to support a meaningful transition. These measures must factor in flexibility and time, while ensuring a consistent pathway, as we and our clients navigate towards achieving common sustainability goals.

Banks are taking a proactive approach in laying out their own transition plans, including targets across various time periods and limits on the most harmful impacts that will ultimately steer their portfolios. How the portfolio looks today will be very different from to how it will look going forward. The very economies we support are undergoing a seismic shift, and we all have to understand and manage new risks in a way that we have not consistently done in the past.

By facilitating real transition for our clients, we are also mitigating and managing ESG risks.

To that end, we are working closely with our clients to understand their transition plans. We complement that engagement with a range of other initiatives, including deep-dive assessments of key sectors and our transition financing approach. By facilitating real transition for our clients, we are also mitigating and managing ESG risks.

One notable challenge is our major dependency on reliable data, not just on the status quo but more importantly forward-looking data. Nordea continues to invest and engage with clients to overcome this challenge, but it is a dependency that must be recognised. Having thoroughly vetted, structured ESG data is a prerequisite for developing models that can adequately quantify how ESG risks materialise, which also limits the speed at which banks and supervisors can move ahead.

Furthermore, it is important for supervisors to understand the markets and sectors in which individual EU banks operate. Even within Europe, physical and transition risks differ from one region to another. For example, the physical risk of water scarcity differs between southern and northern Europe. Transition risks are also lower in the Nordic energy sector, with much of its energy production already based on renewable sources, compared to other parts of Europe and beyond.

Consequently, individual banks will have different focus areas when it comes to steering portfolios, client engagement and allocating capital in a way that is most relevant to the sectors and segments in need of transition. Regulation and supervision must take that variation into account. While we support having harmonised rules, it is not always possible to apply a one-size-fits-all supervisory approach to ESG for all banks in the EU.

As the EU continues to manifest its leadership in climate transition, it is important to focus on the carrot as well as the stick. If policymakers can incentivize the investments needed in the sustainable transition, then we will be there to finance it, to the extent the risks are acceptable. We must avoid a situation where it becomes more advantageous for non-EU banks and non-banking entities to provide the financing and investment needed in the EU. It is the challenge of the century and the opportunity of a lifetime.

To achieve real progress on the sustainability agenda, we need banks that are committed to supporting their clients' transition and a regulatory framework and supervisory practices that support banks in this task. The content, pace and sequence of the regulatory and supervisory agenda must be carefully considered and include a degree of flexibility and predictability to avoid hindering those segments most in need of transition financing.

KAY SWINBURNE

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Tensions between risk management and real world outcomes

ESG is substantially different from most regulatory action seen over the last 50 years. Typically, regulators and banks take much longer to develop, debate and apply regulatory policy. With ESG, given the urgency to act, this simply wasn't an option. We have seen methodologies and data requirements for reporting, stress testing and broader risk management activities develop in parallel with implementation. It was the only approach available, but it has taken many banks into unfamiliar and potentially challenging territory.

Generally, the regulatory push should be seen as a push towards better risk management, reflecting regulators' market stability mandate in action. The policy driver though is net zero outcomes in the real economy. And there is an inherent conflict that risk management might, but doesn't necessarily always, achieve real outcomes. It may encourage short term investment in the 'worst' areas (from a sustainability perspective) where the returns are sufficient, then divestment in the longer term. Real world outcomes require a greater understanding of and investment in the transition. Risk management identifies flooding and wildfire risks but struggles to meaningfully quantify second and third order effects like significant migration flows or large pools of stranded assets. Real world outcomes require a much deeper dive into the complete transformation of sectors.

Banks are struggling with the breadth of 'sustainability risk' and we've only scratched the surface. At opposite ends of the spectrum are areas such as climate risk - where there is more data and attempts can be made to apply traditional financial risk modelling - and then reputational impacts and broader risks around ESG strategy, execution and greenwashing that are distinctly non-financial. In these areas firms have only ever really done 'scenario-based' modelling. The challenge is to bring these aspects together.

Climate risk is being incorporated into traditional market, credit and liquidity risks. Banks already have some of the tools they need, but there is more to do on data and modelling approaches. The ECB has pushed for ESG factors to be included in the consideration of loan origination and monitoring, driving banks to try to incorporate them into credit risk techniques. For now, this is being done in a range of ways with both qualitative and quantitative overlays. In the longer term, we could expect to see it becoming part of underlying core model development. For the broader reputational, social, and governance elements of sustainability, scenario analysis and approaches more traditionally taken for operational or non-financial risk are more likely to persist.

There is an inherent conflict that risk management might, but doesn't always, achieve real outcomes.

There are already different approaches from supervisors to non-financial risks – for example, the use of models for quantifying operational risk in Pillar 1 capital (the AMA) is removed in Basel 4 because of the widespread difficulties in achieving consistency and good quality outcomes. Operational risk moves to Pillar 2 which is more likely to be more scenario-based and is open to variability in outcomes from banks and supervisory regimes.

Returning to the theme of achieving real world outcomes, banks should be encouraged to weight sustainability factors as heavily as profit. Not just to drive shareholder value, but to do the right thing by the planet and people and demonstrate their role in the transition to net zero. Recent focus on the sustainability of banks' business models is key to ensure clarity around what they are doing to support sustainable business.

A sustainability lens should be applied end-to-end across the organisation, to avoid silos – in deals and transactions, new product development and the onboarding of new clients, and in performance scorecards and remuneration. And banks should be encouraged to look across to the second and third order risks - and consider the interactions between them - to find clusters or linkages and identify the unintended consequences.

Climate has been at the vanguard, driven by the recommendations of the TCFD, but nature is no less relevant. Equally, any risk mitigation actions will need to consider social impacts via 'just transition'. Treating any or all of these risks in isolation runs the risk of double or even triple-counting impacts and failing to net off opportunities created.

The breadth of reporting required under CSRD will help to effectively create a checklist of ESG Risks (or related impact areas) that need to be considered - across climate, the environment, nature, social and governance objectives. It will bring clear structure and should compel banks to do meaningful things. Interoperability with the ISSB and SEC standards is to be supported as this will help drive consistency and comparability at a global level, to the benefit of EU banks.

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Transition Finance as a credible risk mitigation strategy to achieve net zero

In order to understand the progress banks and other financial institutions are making with respect to the management of climate and environmental risk, it is not sufficient only to assess the outcomes of scenario analysis, risk assessments and heat maps that demonstrate the most pressing environmental risks. Our supervisors also expect us to embed climate risk in our governance, risk management framework and, perhaps most importantly, our business strategy.

Financial institutions have an important role mitigating financial risk. Mitigating climate risk through transition finance will drive global progress in achieving our collective net zero ambitions.

We have made good progress on governance and risk management. Environmental and social elements are a top priority for bank management teams, and we have the governance structure to support it. We are also starting to better understand where we are most exposed to climate risk across our portfolios, but more work is needed from all of us in this respect.

Creating or adapting business strategy for climate risk will be interpreted in different ways. Our view is that business strategy for climate risk may also be defined as creating a 'plan to mitigate the risk of climate change', in other words, a transition plan.

In creating these strategies, we need to remind ourselves of two very important roles we have as banking institutions; we fulfil a role as risk managers ensuring financial risk is managed and mitigated, but we also have a role as financiers of the real economy, assisting economic progress in the markets where we operate. As a globally significant bank, we play a major role in financing the economies in which we operate, as well as their net zero pathways.

Our government's and clients' net zero commitments form the basis of our transition plan as these guides where we want to be in the lead up to 2050. The sector specific intermediate emissions reduction targets we set ourselves as part of the NZBA commitments guide our capital allocations to finance the transition. In this context, Japan and Asia's transition story is different to Europe's, given Asia's reliance on hard-to-abate sectors for its energy security. As we have outlined in our Transition Whitepaper, these sectors need continuous financing to help them to decarbonise. We view it part of our responsibility to help our clients in hard-to-abate sectors to decarbonise by means transition finance, which ultimately reduces climate risk.

Mitigating climate risk through transition finance will drive progress on net zero ambitions.

Decarbonisation pathways are written through engagement, commitment, and persistence. Net zero cannot be achieved in a niche; we all need to become more focussed on considering net zero as a shared problem, which we need to resolve together, as opposed to just by ourselves.

Divesting from carbon intensive assets means we are kicking the can further down the road to those stakeholders we did not commit to the same decarbonisation pathway. Divestment is not a solution as there is no assurance that actual emissions will decrease, even though divestment does reduce our financed emissions very swiftly. We need to engage with hard to abate sectors and feel we have the responsibility to engage with our clients in all sectors and regions and finance their transition journey. This is the only credible way to deliver a 'just and orderly' transition, without unnecessary shocks to the financial system and the economy. Together, with various collaborators from both the public and private sectors, we intend to consider how the society can mobilize financing for the necessary technological innovations.

Last month, the Japanese Ministry of Economy, Trade and Industry (METI), the Financial Services Agency (FSA), and the Ministry of the Environment (MOE), together with ten global private financial institutions including MUFG and other organizations, launched the Japan Public and Private Working Group (WG) on Financed Emissions to scale-up transition finance through developing complementary metrics in addition to financed emissions. We view this private-public partnership as an important model, which we see as widely beneficial and applicable to other jurisdictions.

To conclude, by moving from risk management to risk mitigation, important strategic decisions that need to be taken to ensure we can continue to manage the risk as well as continue to finance the transition to net zero. The UK Transition Planning Taskforce's Guide is an important framework that helps to guide institutions like ourselves to write a credible transition plan. However, to avoid undue complexity and duplication, we do need to ensure that we continue to drive international consistency in standards.

The overall priority should remain the creation of a properly embedded climate and environmental risk framework, consisting of governance, risk management, metrics and most importantly ensuring integration with the overall business strategy.

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Building trust via data: why sustainability reporting standards must be unified

Progressively, European supervisors appear highly concerned about banks' exposure to physical and transition risks related to climate and environmental risks. In due course they are increasing pressure on institutions to enhance their management of such risks. A primary challenge currently faced by the European banking sector is to measure, address, and report sustainability risks in a suitable manner. While European banks have a good understanding of ESG risks and their implications for classic risk categories like credit and market risks, they are still facing challenges in integrating and measuring climate and environmental risks due to the complexity stemming from this integration.

The European Central Bank (ECB) on the other hand has implemented multiple sustainable risk initiatives for banks, including the upcoming 2023 climate risk stress test. From these supervisory efforts, it has been observed that banks are advancing in their management of climate-related and environmental risks, however, the ECB maintains that progress is not consistent across the industry, and some banks are still lagging. At the EUROFI financial forum in September 2022 the ECB stated unequivocally that supervisors will continue to push banks to improve their systems and management of environmental, social, and governance (ESG) risks.

While regulations concerning sustainability risks are constantly evolving and accompanied by ever increasing supervisory expectations, the European banking sector is rapidly improving in terms of measuring, managing and disclosing ESG risks. European banks are constantly under pressure to implement new requirements, adjust their systems, processes and KPIs, whilst considering the potential interlinkages of various regulations. However, it is no secret that there is still high degree of uncertainty and legal insecurity in the financial market when it comes to practical implementation. Alas: The disclosure requirements for ESG risks are yet to be finalized and are for their better part far from being fully synchronized.

The quality of measurement and reporting finally depends considerably on the availability and quality of relevant ESG data. For example, evaluating the sustainability level of a counterparty requires that the customer possesses the necessary data and provides it to the bank in a manageable format. Gathering this information is challenging and leads to extra expenses for both customers and banks. Additionally, the diverse and comprehensive data requests from various banks could overwhelm customers and discourage them from providing data. As a result, it is vital for banks to educate and inform customers in time about the new data demands.

As global problems require global solutions, we need a global baseline for sustainability reporting.

As things stand, the banking industry is experiencing a shortage of ESG data due to the novelty of ESG risk measurement. To address this, banks must engage with their customers and alert them to ESG requirements. In the past months, Raiffeisen Bank International has made great progress in this area by creating a customer questionnaire that facilitates the customer journey and generates crucial data for disclosure and internal management. Additionally, collaboration and sharing of methodologies among market participants can promote a customer-centric approach.

The adoption of the Corporate Sustainability Reporting Directive (CSRD) in December 2022 can be seen as an important step to address this issue, as it is expected to mitigate the issue of customers receiving varying requests for information and in fact should work to improve the comparability of sustainability risks within balance sheets of financial institutions. These new reporting requirements come with detailed standards applicable to all reporting institutions and companies, which may – to a certain degree – be helpful in unifying the relevant ESG data points and thus improving data availability.

Nonetheless, there remain evident discrepancies in the approaches and rating methodologies of financial institutions regarding ESG risks as well as sustainability risk reporting, leading to a lack of consistency in the market. Additionally, many financial institutions' portfolios are not in line with their net-zero commitments, highlighting a larger gap between the net-zero goal and the real economy, globally. As a result, markets, investors and individuals have become increasingly mistrustful, undermining the EU sustainable finance strategy.

It is essential to recognize that climate crises and distrust of markets participants are not solely a European issue, but a global one. High-quality, consistent, and comparable climate-related data and metrics are critical to providing reliable and resilient information to market participants. Therefore, implementing a global baseline for sustainability reporting is a priority, with local initiatives keeping compatible and coherent with globally agreed approaches to avoid fragmentation. Global problems require global solutions.