Sustainability risk in the banking sector

1. European banks are still not adequately managing climate and environmental risks despite existing guidance and best practices

The Chair stated that climate change concerns have increased since the 2015 Paris Agreement. Climate change should be addressed globally and in a coordinated manner. European banks, supervisors and other international institutions are working together to build common criteria to deal with sustainability risk.

The Single Supervisory Mechanism (SSM) has carried out a significant number of activities related to climate change. It has expressed the concern that European banks are still not adequately managing climate and environmental risks. The SSM observes that, although 85% of banks have basic practices in place in most areas, they still lack more sophisticated methodologies and granular information. Stress testing exercises also show that banks face significant challenges in terms of data availability and modelling techniques. Supervisors acknowledge that they need to further reflect on areas such as bottom-up stress test scenarios, long-term methodological approaches, and the means to help banks overcome the challenge of data availability.

1.1 From a remote sustainability risk toward a day-to-day issue for banks

A Central Bank official stated that assessing climate and environmental risk is a high priority. For a long time, it seemed to be a long-term risk only, but it now needs to be taken into account in day-to-day business.

As the supervisory part of the European Central Bank (ECB), the SSM is responsible for supervising the 110 largest banks in Europe. The SSM has been working on climate and environmental risks for a number of years. The SSM issued supervisory expectations in 2020 and is expecting banks to deliver on them by the end of 2024 at the latest. After issuing the supervisory expectations, the SSM asked banks to carry out self-assessments of how well they were already fulfilling the expectations. Joint supervisory teams have been closely discussing the issue with banks, and each bank has made a plan to fulfil the expectations by the end of 2024.

The SSM also conducted a climate stress test in 2022. The SSM has carried out a deeper thematic insight into many banks to better understand how they are working. Overall, banks are improving, but there are still laggards. Many banks need to make improvements in many areas. For example, only one out of five banks take climate risk into account when they are granting new loans.

1.2 Limited climate-related data availability and issue appropriation by banks' management and governance are still preventing banks from understanding sustainability exposures and translating the issue into strategic options. Implementing SSM's compendium is essential in this respect

A Central Bank official stated that it is difficult to obtain good data. Many banks are using proxy data. In order to fully understand exposure, more detailed data are required. The SSM is engaged in many discussions with banks on this. Not all managers or boards of directors are focused on the climate risk issue. More needs to be done to be more strategic in treating climate and environmental risk and taking those risks into account in business plans.

This year, the SSM has requested that all banks can categorise their climate risk and will be able to assess the impact on their balance sheets. The SSM has also requested that banks ensure they have a good governance structure in place by the end of 2023. The third pillar is that, by the end of 2024, banks are expected to completely fulfil the supervisory expectations. This will be challenging, but that does not mean the work should be neglected. The SSM tries to be as helpful as possible, but banks need to decide how green they want to be. The SSM would like to see banks account for climate and environmental risk in their risk management frameworks in the same way as they manage other material risks. The SSM has published a compendium including best practices to help inspire banks to do more in this area.

2. The consistency of transition planning and climate-related risk assessment is essential for the banking sector effectively supporting both an early and orderly transition, financial stability, and economic dynamics

A Central Bank official stated that it is important that the financial sector plays its part by supporting clients' own plans to transition. The Bank of England's work was similar to that of the ECB. The Bank of England's supervisory expectations were published in 2019 and came into force at the end of 2021. It also ran an exploratory stress test, the results of which were published in 2022. Climate is now embedded in the day-to-day supervisory discussions between the Bank of England and the banks it supervises. The results of last

year's stress test indicated that an early and orderly transition on an economy-wide basis is likely to be optimal from a financial stability perspective. Therefore, it is in the interests of banks, insurers, and other parts of the financial sector to support that transition.

Transition plans are likely to provide financial institutions with the information they need to manage their transition risks. Transition plans will underpin discussions between supervisors and firms. This will enable an overall assessment of the way in which firms are managing their climate risks. Transition plans are going to be of interest not only to supervisors, but to a broader range of stakeholders in the financial sector. As firms develop transition plans, they should keep this broad audience in mind.

In terms of what supervisors will expect from a transition plan, a clear statement of the firm's transition strategy is key, as are the specific steps that the firm is going to take and the associated assumptions and risks. Supervisory discussions will take place around these areas to better understand how firms are assessing the risks associated with their transition plans.

3. Cooperation between the public sector and the banks and their customers, is necessary to enable transition plans to clarify the magnitude of the transition finance required by carbon intensive economic sectors and support the credibility of banks' net zero targets

3.1 Transition planning is a strategic effort to build a credible set of actions that achieves net zero

An industry representative stated that climate risk mitigation should start with the most emission intensive sectors. It is important for banks to take proactive steps with these sectors to drive balance sheet transition to net zero. Banking institutions have two roles. On the one hand, banks are risk mitigators and risk managers. On the other hand, banks are financiers of the real economy, including the pathway to net zero.

Since committing to net zero, MUFG has been actively engaging clients in the hard-to-abate sectors about their own pathways to net zero. MUFG has acted as a chair of the Net-Zero Banking Financing and Engagement group. This group published a transition finance guide to better understand the dependency between banking and the real economy and how banks can support transition. Secondly, MUFG published a transition white paper last October, describing its experience of engaging clients in the top six hard-to-abate sectors in Japan. This work has been the result of senior-level discussions with CEOs and CFOs of large Japanese clients on their net-zero journey.

3.2 The availability of credible carbon intensive sectors' transition pathways supported by legible and globally comparable transition plans is necessary

An industry representative stated that banks cannot achieve net-zero financing unless they help their clients achieve net zero. MUFG's objective is to continue to support its clients in decarbonisation through transition finance. MUFG also wants to draw attention to the differences between the transition stories in Japan and Asia compared with Europe and the US. At the end of the summer, MUFG will be publishing a new iteration of this work focusing on decarbonisation pathways for the hard-to-abate sectors and exploring how best to deploy capital to support Japan's transition to net zero. A credible transition plan is the way to address climate risk. The foundations for transition planning have already been laid out by the Task Force on Climate-Related Financial Disclosures (TCFD) and in the future International Sustainability Standards Board (ISSB) disclosures.

Transition plans need to be credible and globally comparable. The Glasgow Financial Alliance for Net Zero (GFANZ) has already published guidance based on industry best practice. The EU and other jurisdictions should adopt a similar approach and embrace international consistency. The transition plan is an effective strategy for addressing climate change. It should include setting goals, actions, and accountability mechanisms, aligning business activities with the path to net zero by delivering emission reductions in the real economy.

3.3 For climate related transition to be credible, regulatory timetables and objectives should be voluntarist but realistic, and fit to both local and sectoral specificities

An industry representative stated that it is important for banks to facilitate clients' transition plans. The ECB and the policymakers are doing the right things overall, but if the regulatory agenda is pushed too much, then it becomes counterproductive. Technological transitions take half a generation, so it will be 10 or 15 years before society can adjust. Banks need to be credible in the short to medium term. Through target-setting and investing in data, banks need to show how they implement climate impacts in their risk frameworks, credit decisions, education and training among employees. One model cannot be implemented for all. There is a need to respect where institutions are operating and to adjust regulatory requirements to different needs. Regulators and policymakers should not decide which technologies are best for climate transition. That is the role of the open market. Nordea has set a very ambitious target of reducing financed emissions by 40% to a net figure of 50% by 2030 and is well on track to meet that. By 2050, Nordea is going to be one of the net-zero emitting banks.

In terms of how policymakers and supervisors should create structures so that banks can facilitate real transition, thereby mitigating or managing risks, an industry representative stated that there have been many changes from regulators and policymakers with a short implementation time. There should be flexibility and understanding that the time needed to implement regulatory requirements will differ.

3.4 Closing data gaps and progressing on transition planning are the next two efforts banks will have to provide

A Central Bank official stated that the Bank of England spent 2022 assessing UK banks' progress against the supervisory expectations that became effective at the end of 2021. There has been mixed progress, with some firms ahead of others. There have been significant advances around governance. Firms are assigning responsibility for climate risk at board and executive level and discussing the issues. There are two areas that are particularly notable as ones in which more progress is needed. The first is scenario analysis, which is not yet embedded in the considerations that firms make when defining strategies and making core business decisions. Secondly, there are significant data gaps for firms to identify and act upon.

4. Banks are strongly involved in improving the quality of climate related risk assessment, which should converge progressively. The forthcoming provision of sustainability data by corporates will be an essential contribution

4.1 Banks effectively managing climate related risk involves investing, mobilising skills, and producing a considerable amount of new data based on new standards

An industry representative stated that, when financial institutions were asked for the initial data, the structures were very loose, with the intention that the data would be used to clarify what institutions needed to do to improve. It is important not be too hard on financial institutions. Some players are very advanced, and others are less sophisticated, but that is to be expected. More caution is needed in relation to those banks who are currently classified as laggards. Conclusions should not be drawn until corporates are mandated to provide good quality data. Assurance is needed that financial institutions can rely on the data coming in. This is a work in progress and should be viewed as such.

Financial institutions see the societal need for this work, so best efforts are being put in place. In the global fora, many banks are working collegiately and collaboratively to come up with standards. Making sure best practice is known and shared is an important step. There are large firms that can implement this to a very high standard, developing a risk management ecosystem that takes sustainability risk to the same standards as current financial modelling. Other firms will take a lot longer to get there and will need some assistance from supervisors and regulators. The progress made is surprising, because the demands given to the banking sector during early data collection by the ECB, the Bank of England and other regulators around the world were not prescriptive. Banks are making progress, but there is a long way to go, so working with legislators, regulators and supervisors is going to be important.

In terms of the main challenges for corporates in disclosing sustainability risk information as required by the Corporate Sustainability Reporting Directive, an industry representative stated that the entire industry is highly committed towards the transition path. Stock-listed companies in CO2-heavy industries are challenged every quarter to outline their path towards transition. One challenge for financial institutions is reporting. It is possible to buy and sell energy on the spot market without knowing how that energy is produced. Companies have ideas for climate transition, but some of these solutions and technologies will need 10 or 15 years to become more broadly available. There is a clear commitment from society, industry and the financial industry to go down this transitional path. The financial industry is eager and committed to supporting clients in their transitions.

4.2 Working closely with banks' clients and introducing additional underwriting and risk management policies in internal arrangements are some of the challenges posed by sustainability related risk

An industry representative stated that cooperation is important. Policymakers have set the targets and ambitions. Clients are legally obliged to deliver data by 2024. Banks can contribute by working closely with clients. Raiffeisen has a dedicated team in corporate finance to support its clients with best practices. It is necessary to ensure that the loan capacity is available to be repaid, so good underwriting criteria and knowledge of how to underwrite a project are required.

An industry representative stated that it is important to identify best practice and who is responsible for delivering it within an institution. Engagement at the top level is important. One cannot go wrong by adopting the same attitude that already exists towards other risk management processes. Trying to deal with this differently will result in different solutions, which will never be sustainable. The same quality and rigour should be maintained for both ESG sustainability reporting and financial reporting.

5. Improving sustainability-related disclosure and risk assessment requirements while avoiding possible duplication or conflicts globally is necessary and triggered ongoing efforts

An industry representative stated that MUFG appreciates and supports the Japanese government's efforts to ensure that the regulatory framework remains globally consistent. The EU and the UK are well advanced in developing sustainability standards. This March, Japan announced that it will incorporate ISSB standards in its own sustainability reporting rules, to be published in

2024. Also, a public and private working group has been established for finance emissions. Japan is working closely with other Asian countries to support their transition pathways.

A Central Bank official stated that the climate crisis is here now, so it is not possible to wait for regulation to arrive. This is why the SSM has issued supervisory expectations, conducted stress tests and had very close dialogue with banks. The Basel Committee and its taskforce on climate-related financial risk have been working on this for a while. The SSM's Vice-Chair is co-chairing this taskforce. The international view has been merged into the Basel regulation. The Basel framework is important because of the number of global cross-border banks. The Basel Committee has issued a Q&A to make sure there is broad agreement among supervisors on how to apply Pillar 1 for climate risk. Last year, the Basel Committee published a guide to supervisors on how to include climate risk in Pillar 2.

There are a number of initiatives relating to the third pillar on disclosure. The Basel Committee will soon issue a consultation paper to ensure a joint approach on disclosure. There is a holistic approach within the present framework. The ultimate goal is to assess climate risk in the same way that all other risks are assessed on a bank's balance sheet.