Climate and environmental risks in the banking sector

1. Most significant difficulties faced by banks attempting to assess climate risk

The Chair stated that both transition and physical risks must be considered in addressing the existential challenge of climate change. The difficulties relevant to facing physical and transition risks are becoming more salient each year. G20 financial institutions have close to $22 trillion of exposure to carbon intensive sectors.

Work is ongoing by international organisations, supervisory authorities, and regulatory bodies to foment a global transition. The panel would consider the actions taken by banks and financial institutions in this regard and recommend actions to take the transition forward in two rounds of discussion: the first on the environmental, social, and corporate governance (ESG) practice of banks and the second on the regulatory framework. The panel are asked to describe the most significant difficulties faced by banks in attempting to assess climate risk.

1.1 Data availability, accuracy of methodologies, addressing the long term and forward-looking nature of sustainability risks, customers and sectoral and regional transition plan availability are among the many challenges ahead

A Central Bank official commented that availability and quality of data and its interpretability from a financial point of view is a key challenge faced by banks when assessing climate-related risk. Different banks report data based on different standards, which is mitigated somewhat using data from third-party companies, and different countries have different approaches, regulations, and paths to decarbonisation.

The methodologies available to measure climate-related risks, which are forward-looking and long-term, lack sophistication. Transition planning, while a valuable tool for management of climate risk, must be based upon the plans of banks' clients. These clients have yet to develop fully mature transition plans. There is also a lack of expertise in the sector. Litigation might become a challenge in the future. In some cases, social pressure is increasing, which might accelerate the impact of climate risk on financial institutions' balance sheets.

Supervisors can support banks and financial institutions to continuously engage with their clients. Supervisors share many of the challenges of banks when assessing climate risk and are attempting to overcome them through groups of external experts and internal networks.

1.2 The heterogeneity of banks' approaches adds to the challenge

An industry representative noted that financial materialisation of the financial risk of climate change is still limited in bank's balance sheets, not allowing for ex-post empirical evidence or ex-post risk differentiation, nor the use of the usual back-testing. Methodologies between banks are highly divergent and it is difficult to obtain high quality data. Banks and financial institutions are yet to fully appreciate the potential impact of climate risk on business activities. Relying on stress testing as a single tool might not be sufficient to properly evaluate climate risk management. A holistic view must be taken of the metrics and tools available.

An IFI representative stated that financial institutions are in one of three categories: early stage, developing practice or advanced practice. In the early stage, institutions might quantitively assess the physical risks of a number of investments. When exhibiting developing practice, institutions might start to undertake qualitative assessment. Advanced practice, wherein physical and transition climate risks are identified, described and both quantitively and qualitatively assessed for inclusion in risk management and business planning, is the aim. However, few institutions are currently in this position.

2. Stress testing is a key tool for assessing climate-related risk in a forward-looking way. Progress on client-specific data, modelling, accuracy and granularity is still needed, while mainstreaming stress testing among banks and their clients

The Chair observed that stress testing is another key focus. A regulator stated that, in addition to data disclosure, a forward-looking approach must be developed to foment a deeper understanding of climate-related risk.

The Autorité de Contrôle Prudentiel et de Résolution's (ACPR)'s first pilot exercise in 2020 showed an overall moderate level of vulnerability in the French financial sector and in Europe as a whole. The exposure of French institutions to the sectors most impacted by transition risks is relatively low. The cost of risk and the probability of default have increased. In some cases, the cost of risk is tripled. Insurance claims on physical risks might multiply five or six times in certain French areas between 2020 and 2050 and some parts of the country are at risk of being uninsurable.

The European Central Bank's (ECB) stress testing has resulted in a number of lessons learned. Stress testing is instrumental in identifying and quantifying the financial risks of climate change and it is a complex exercise. Progress has been made in terms of improving scenarios and methodologies, but there is still more to do.

Testing must become operationalised. There must be investment in climate-related data collection in order to lessen reliance on proxies. Methodologies and models must be improved, and customers' transition plans integrated into banks' own. An industry representative agreed that, to ensure accuracy, there must be a bottom-up approach to transition planning. The macroeconomic assumptions made by the Network of Central Banks and Supervisors for Greening the Financial System (NGFS) must also be taken into consideration. External validation is key to ensure a robust approach.

An industry representative commented that the results of stress testing might be reflected in capital requirements in the future, but stress test methods are not ready yet and are still developing and are currently not accurate enough to be used directly for risk management in his view. Also, in relation to climate related scenario analysis, it is key to improve the scenarios to help financial institutions predict risks for long term into the future. Such improvements will be supported by deep understanding of their clients' business, industrial structure, and transition plans, which could be obtained through engagement with the clients. Financial institutions need to work with various parties including regulators and clients to improve the scenario analytical skills.

The Chair summarised that both stress testing and integration must move from the pilot stage into operationalisation.

3. A key challenge for financial institutions is to become able to take the additional medium- to long-term strategic risk specific to the support required by the clients' transition

An industry representative explained that financial institutions must be able to take strategic risks in order to provide financial support for their clients' transitions based on careful risk management and ongoing engagement. Not only banks but the clients of financial institutions are also planning to make transition, and this will be important for our society to achieve transition. Financial institutions will support the transitions of their clients by providing financing if the clients meet certain criteria, a mere exposure reduction to carbon related industry will not achieve the transition. Development of a risk control framework around carbon-related sectors aids this process. Client exposure to carbon intensive sectors should be assessed alongside the measures in place to address transition status of the clients.

Support for the transition could lead to a temporary increase in Financed Emission for financial institutions so it is important to establish transparent process to confirm the reliability and transparency of clients' transition strategies especially when financial institutions need to explain the efforts to respond to climate change to the stakeholders. As such, financial institutions need to pursue good balance between transition support financing and risk management.

The Chair agreed that transition plans are a key aspect of the debate.

4. Transition planning is emerging as the prevalent tool to manage climate-related risks with a forward-looking mindset

An IFI representative observed that transition planning presents a valuable opportunity for banks to ensure that the institution itself is green, in line with the Paris Agreement. Transition plans are emerging as the primary tool by which institutions can do this and be forward-looking when attempting to manage climate-related risks.

Transition plans allow financial organisations to take into account their specific starting point and move to the next level of climate-related risk analysis. Climate risk integration must be accompanied in the transition plan by transparency around climate-related risk disclosures, which in turn requires the development of more effective data infrastructure.

5. Transition planning is the operational tool to assess and achieve banks' sustainability risk reduction

5.1 Key transition planning success factors

A regulator observed that transition planning is the action required to push the banking sector towards decarbonisation. There are three high-level factors to make such a plan effective. First, it must be credible and align with the means of banks and their counterparties. Ambitious targets are of no use if there is no way for them to be met. Second, it must be consistent with EU climate-related objectives and sectoral transition plans. The whole environment must be taken into account.

Finally, it must be compatible with existing requirements, including Pillar 3 Implementing Technical Standards (ITS) and Corporate Sustainability Reporting Directive (CSRD) accounting standards. Information should be standardised to facilitate compatibility and the latest scientific advice must be considered.

An IFI representative stated that transition plans must also include targets on emission reductions. The end

goal of net zero by 2050 must be taken into account during the planning process and applied to both financed emissions and those of the company itself. A bank's fossil fuel policies should be supported by strong internal governance, intent on pursuing climate risk measures. The NGFS May 2023 stocktake indicates that existing transition plans are too focused on either strategy or risk. The two factors must be merged and balanced for success.

5.2 The reliability of transition plans and their consistency with banks' environments are two critical factors

The Chair noted that transition plans form an important element of stress testing. An industry representative stated that stress testing is only one approach. Banks are responsible for managing their own risk, but there is an evaluation role for supervisors to play. The European Banking Authority (EBA), ECB and ACPR hold the key to achieving better risk management, as they consider business model, governance and risk and capital through three of the four European supervisory review (SREP) pillars.

Alignment of a bank's transition plan, commercial offering, governance, risk policies and stress testing is crucial to all parties concerned. Validation of decarbonisation plans by the Science Based Targets initiative (SBTi) ensures their adherence to scientific standards. It is also wise to incorporate climate risk into a bank's credit granting policy and credit positioning.

Both banks and supervisors should take a holistic view of climate risk exposure and strategy. There is a lack of expertise and resources within supervisory bodies, leading to reliance on external independent bodies. The latest European Commission consultation might help in this regard, by providing a robust framework to ensure consistency.

5.3 Guidelines and regulatory and supervisory standards are necessary

A regulator stated that the EBA would develop guidelines, in line with Basel Committee discussions, to inform the transition planning process. The first priority would be to define the content required. Supervisors would also have an interest in ensuring that transition plans are actually implemented, which might require some additional powers. It is likely that such powers would be granted by the upcoming Capital Requirements Directive VI (CRD VI).

Climate risk is arguably a new risk, not an addition to those existing within the SREP framework. It must be integrated as its own category, as it has the potential to impact on governance, business models, strategy, and other risks. Within the Pillar 2 framework, supervisors might recommend that banks adjust their business models according to climate-related risk, as well as asking for higher capital requirements.

6. Expected impacts of climate-related risk on the three pillars of banking regulation

The Chair noted that supervisory bodies appeared to have the upper hand as to the effective assessment of climate-related risk.

A Central Bank official highlighted the final EBA paper on incorporation of climate risk into Pillar 1. It is to be treated not as a separate risk, but as an element of traditional financial risk. For example, it is recommended that climate risk be taken into account when rating or validating collateral as part of credit risk standards. In such cases, the internal ratings-based approach (IRB) is favoured, as its models are flexible. It is important that climate change-related factors are taken into account in operational risk, as some might trigger operational losses.

In terms of Pillar 2, supervisors are forced to rely on the 2021 paper issues by the EBA, as well as the Single Supervisory Mechanism's (SSM) approach to including climate risk in SREP analysis. The latter includes climate-related risks as a factor that might impact traditional financial risk, not a risk in its own right. The ITS from the EBA has put Pillar 3 into practice and institutions are beginning to publish data homogeneously.

The Chair summarised that it is clear the sector is moving forward in the area of climate-related risk. It is hoped that institutions will work together to facilitate a transition to the benefit of all in a timely manner.