EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Supervisory approach to climate-related and environmental risks

Joint Vienna Institute webinar

Disclaimer: the views expressed in this presentation represent solely those of the presenter and not those of the European Central Bank

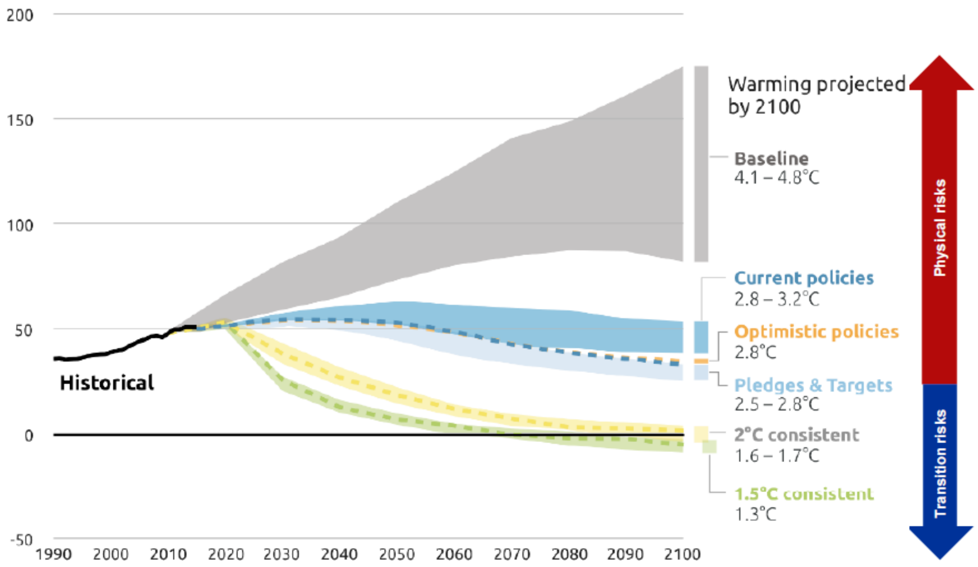
21 June, 2021

Guan Schellekens
Lead Supervisor, DG Specialised Institutions & LSIs

Climate-related risks in the euro area

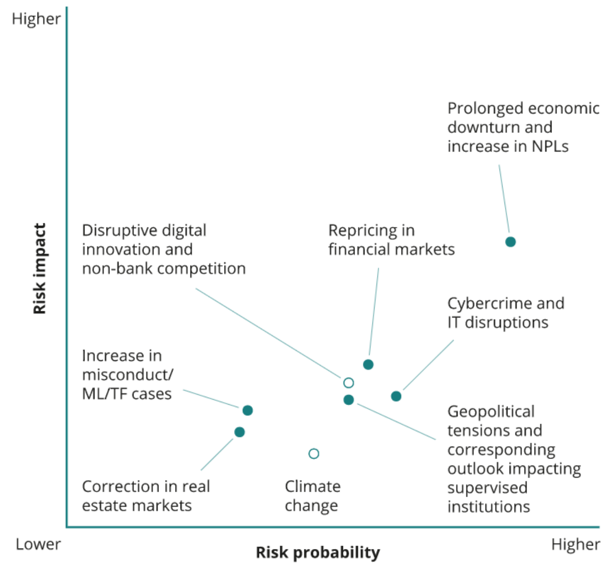
Climate risk scenarios: Projections of carbon emissions and global warming

(emissions of CO_2 in gigatonnes per year)



Sources: Climate Action Tracker, Warming Projections Global Update.
Note: December 2019 projections.

SSM Risk Map for 2021



Source: ECB and national competent authorities.
Note: Dots with a white fill denote risk drivers that are expected to increase strongly over the next five years; "ML/TF" refers to money laundering and terrorist financing; "NPLs" refers to non-performing loans.

The SSM Road Map on Climate Risk: overview

1 How are SSM banks addressing climate risks?

Identify a **sample of SIs/LSIs** and collect evidence on their awareness, exposures and approaches to climate risk

Contribute to **on-going policy work** within, inter alia, EBA and NGFS

2 Develop and maintain active dialogue

Establishing a constant dialogue to monitor developments:

ECB GUIDE

- Set expectations
- Industry workshops
- Alignment with NCAs' work

Enhancing SSM common position in international fora

3 Update supervisory practices

Adapt current supervisory tools and develop new ones to address climate risk: e.g.

- On-going supervision
- SREP, ICAAP/ILAAP
- Stress test

→ **Changes to SSM Manual and Processes**

SSM Climate Risk Coordination Group (CRCG) chaired by DG-SPL

Exchange best practices within the **NGFS**

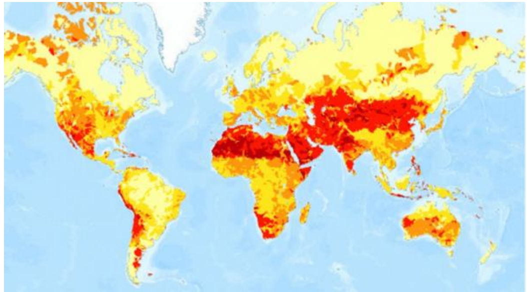
Constant **dialogue** with key **stakeholders**

Integrate **future EBA products** in our framework

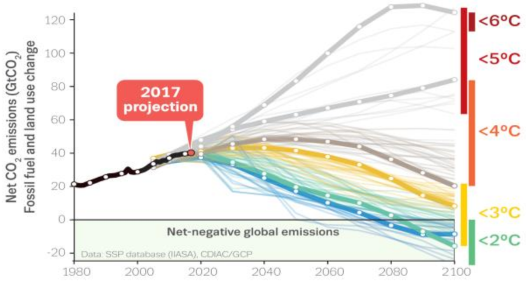
Full alignment with EUCOM, EBA, NGFS and BCBS work and timelines

Characteristics of climate-related and environmental risks

1. Far-reaching impact



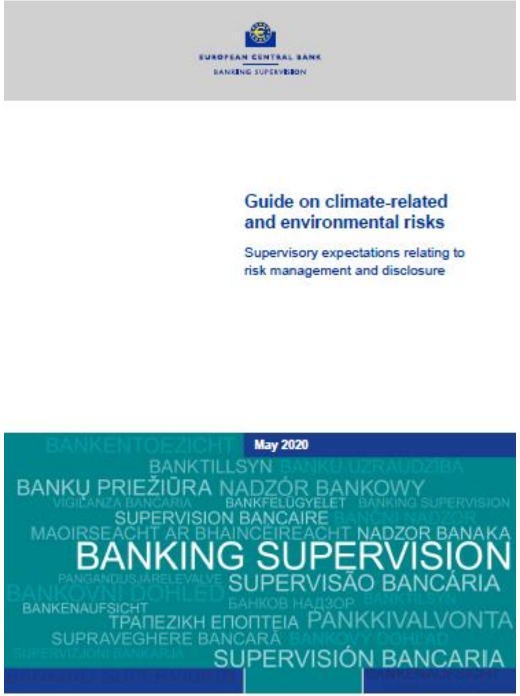
2. Extended time horizon



3. Short-term action

The ECB is of the view that institutions should take a
forward-looking, comprehensive and strategic approach
to considering climate-related and environmental risks.

ECB Supervisory expectations



- Climate-related and environmental risks (C/E risks) are a key risk driver for euro area banks
- Supervisory expectations:
  1. Provide transparency about the ECB's understanding of a prudent approach to managing climate-related and environmental risks.
  2. Enhance the industry's awareness and preparedness for managing them
  3. Contribute to a level-playing field in the euro area, while ensuring consistency with existing and forthcoming guidance from NCAs
- Supervisory expectations exclusively deal with the management and disclosure of prudential risks under the current framework.
- The ECB Guide is consistent with EBA, NGFS and NCA publications

The Guide covers expectations related to four key elements

Business models and strategy

Chapter 4
Business environment & business strategy

Governance and risk appetite

Chapter 5
Management body, risk appetite, organisational structure & reporting

Risk management

Chapter 6
Risk management framework and processes & scenario analysis and stress testing

Disclosures

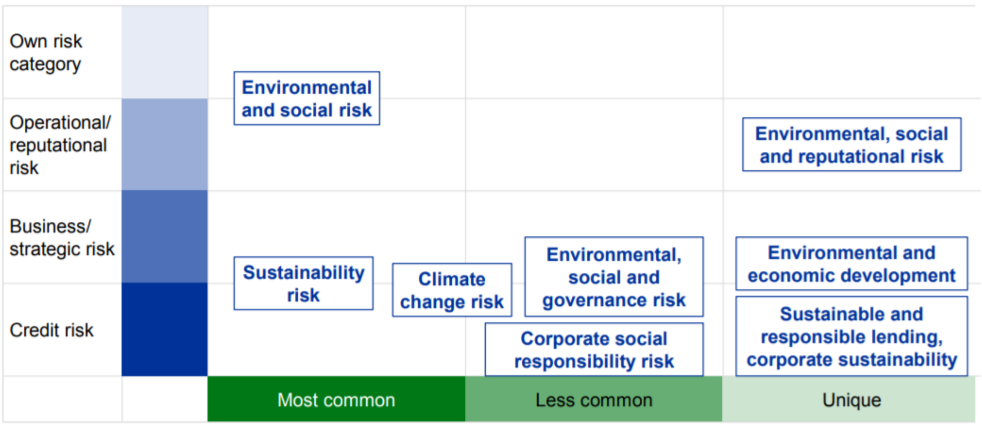
Chapter 7
Disclosure policies and procedures, and disclosure content

Observations: banks’ approaches

Figure A

Climate-related risks: observed clustering with other risks in risk taxonomies and inclusion in risk types

Climate-related risk taxonomies

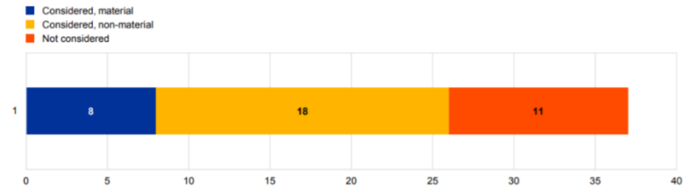


Notes: The location of rectangles is based on the most frequent inclusion of specific terminology in a certain risk category and the observed frequency for doing so. The size of rectangles has no meaning. The analysis of climate-related risk taxonomies reflects the practices of the 26 banks that do consider climate-related risks in their risk identification processes.

Chart A

Risk identification and materiality of climate-related risks

Climate-related risks considered in risk identification

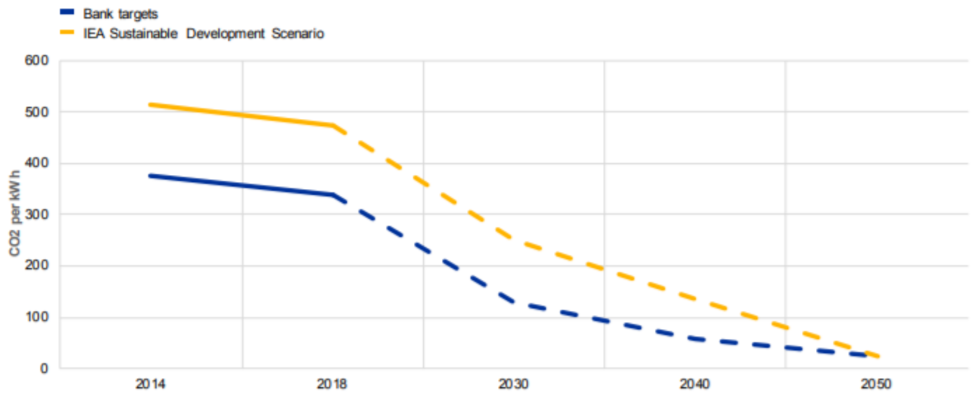


Observed practices: banks' strategies

Box 4
Observed practice: Carbon intensity targeting and climate resilience of the balance sheet

The ECB observed that several institutions aim to keep the carbon content of their financed energy mix in line with the target of remaining well below 2°C as provided for in the Paris Agreement (2015).

Chart A
Carbon intensity targeting



Source: World Energy Outlook 2019.

Table A
Stylised example of the mapping of climate-related risks to financial impacts

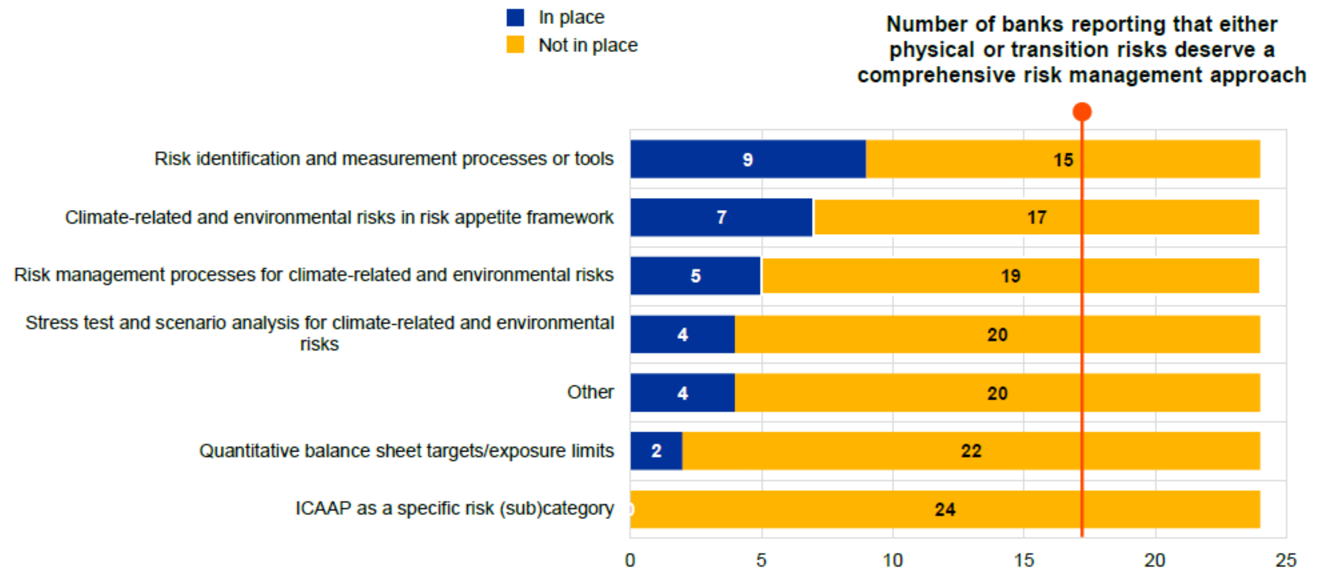
Climate-related risk drivers	Potential financial impact	Time frame	Impact on risk profile	Impact on strategy
Policy and legal	Depreciation of assets of carbon-intensive companies in the investment portfolio.	1-3 years	**	****
Technology	Corporates clients in the car industry affected by a substitution of existing products and services.	3-5 years	*	***
Market sentiment	Consumers and investors favouring more sustainable products	1-3 years	****	*
Acute physical risk	Damage to property and assets in high-risk locations	1-3 years	*	**
Chronic physical risk	Increased costs for customers to address damages or losses caused by climatic incidents affecting their ability to pay	1-3 years	*	**

Source: ECB.

Observations: banks' risk management

Banks' risk management approaches to climate-related and environmental risks

(list of risk management approaches; number of banks)



**Source: ECB Annual Report on supervisory activities, 2019.*

Observations: banks' disclosures (1/2)

Overview of institutions disclosing basic climate-related information

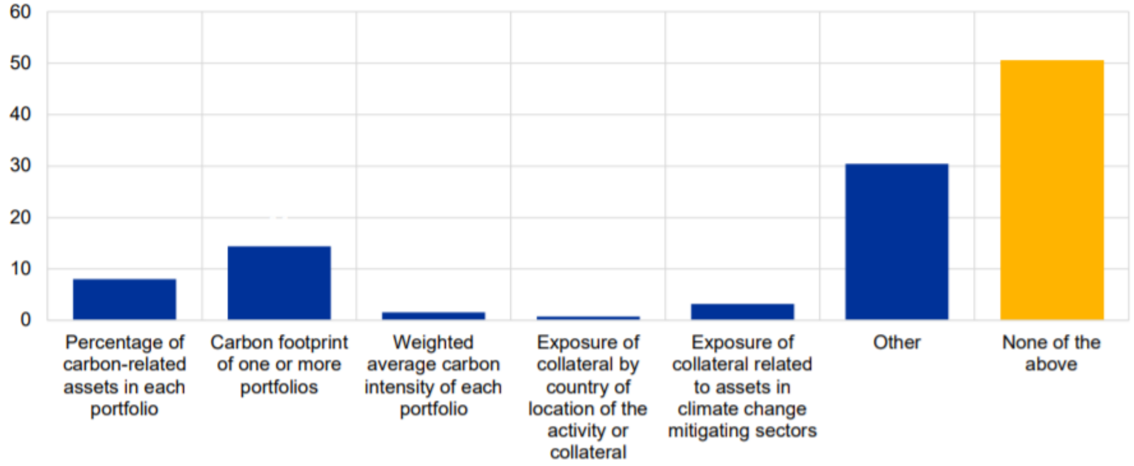
Category		Metric	Percentage
Disclosure policies and procedures	1)	Percentages of institutions that substantiate consideration of climate-related risks as immaterial in their disclosures (where the institution reports it deems the risks to be immaterial)	8%
	2)	Percentage of institutions disclosing methodologies, definitions and criteria associated with any figure, metric or target reported	45%
Business strategy	3)	Percentage of institutions describing the potential strategic impact of transition risks in the short and long term	30%
	4)	Percentage of institutions describing the potential strategic impact of physical risks in the short and long term	24%
Governance	5)	Percentage of institutions describing the board's oversight of climate-related risks	55%
	6)	Percentage of institutions describing the organisation's processes for identifying, assessing and managing climate-related risks	57%
Risk management	7)	Percentage of institutions describing how climate-related risks feed into credit-granting policies	54%
	8)	Percentage of institutions making any reference to the use of scenario-analysis or stress testing	29%
Metrics and targets	9)	Percentage of institutions disclosing at least one metric and one target	37%
	10)	Percentage of institutions disclosing a key performance indicator or key risk indicator	26%
		Percentage of institutions that disclose all of the above information	**3%**
		Percentage of institutions that disclose less than half of the above information	**58%**
		Percentage of institutions that disclose none of the above information	**16%**

Observations: banks' disclosures (2/2)

Chart 8

Has the bank disclosed any climate metric? If so, which ones?

(percentages)



Source: ECB

Planned follow-up actions

Q4 2020
- Issuance of the final ECB Guide on climate-related and environmental risks

2021
- Bank's self-assessment and implementation plans
- Gap analysis on disclosures

2022
- In-depth supervisory assessments of banks' practices
- Supervisory stress test dedicated to climate risk

Ongoing work on the integration of ESG risks in **capital requirements** (EBA)

Ongoing work on **bridging climate risk data gaps** (NGFS)

Annex

Framing the impact on the financial sector

Risk drivers

Physical

Climate change and environmental degradation

Transition

Adjustment to a lower-carbon & more circular economy

Transmission channels

Corporates/sectors:
- lower profitability
- legal claims

Households:
- devaluation of assets
- loss of income

Public budgets:
- investments
- relief payments

Financial and prudential risks

Credit risk

Market risk

Operational risk

Liquidity risk

Profitability

Risk management

Governance and risk appetite

Business models and strategy

Observed practices: banks' disclosures

Policies and procedures	Most of the assessed institutions refer to climate-related risks in their public disclosures in some form, predominantly in their annual report. A limited number of institutions disclose information on the outcome of their materiality assessment**. For those qualifying the risk as immaterial, there is typically no substantiation**. A minority of institutions disclosing metrics and targets appropriately reference methodologies, definitions and criteria.
Business strategy	**Less than a third of the institutions disclose the potential impact of transition risk on their business model in the short and long term.** This proportion is even smaller for physical risk. In limited cases only, institutions disclose clear mapping of climate risks on existing categories of risks, impacts on the strategy and mitigating actions to be implemented..
Governance	**Just half of the institutions provide disclosures on either the board's oversight of climate-related risks or of opportunities.** While some institutions refer to the involvement of the Board in climate-related topics, the form of this involvement is not always described.
Risk management	**One in two institutions have publicly described their processes for identifying, assessing and managing climate-related risks, of which only a minority have done so comprehensively**. Less than a quarter of institutions refer to the use climate-related scenario analysis in their disclosures and even fewer to stress testing, while many institutions also disclose that the work is in progress.
Metrics and targets	**Just over a third of the assessed institutions disclose both targets and metrics, and a stark minority discloses quantitative information about the carbon intensity of the portfolios**. Reporting of GHG emissions typically incorporates scope 1 and 2, and more rarely downstream emissions (scope 3) from the portfolios. Targets are not always supported by the relevant metrics, making it challenging to assess the performance of the institution against them.

Main messages from the guide (1/3)

Business models and strategy

1. Business environment	Institutions are expected to **understand the impact** of climate-related and environmental risks on the business environment in which they operate, in the **short, medium and long term,** in order to be able to make informed strategic and business decisions.
2. Business strategy	When determining and implementing their business strategy, institutions are expected to integrate climate-related and environmental risks that **impact their business environment** In the short, medium or long term.

Governance and risk appetite

3. Management body	The management body is expected to consider climate-related and environmental risks when developing the institutions' overall **business strategy, business objectives and risk management framework**, and to exercise **effective oversight** of climate-related and environmental risks.
4. Risk appetite framework	Institutions are expected to **explicitly include climate-related and environmental risks in their risk appetite** framework.
5. Organisational structure	Institutions are expected to **assign responsibility** for the management of climate-related and environmental risks within the organisational structure in accordance with the three lines of defence model.
6. Risk reporting	For the purposes of **internal reporting**, institutions are expected to report aggregated risk data that reflect their exposures to climate-related and environmental risks with a view to enabling the management body and relevant subcommittees to make informed decisions.

Main messages from the guide (2/3)

Risk management	
7. Risk management framework	Institutions are expected to incorporate climate-related and environmental risks as **drivers of established risk categories** into their existing risk management framework, with a view to managing and monitoring these over a sufficiently long-term horizon, and to review their arrangements on a regular basis. Institutions are expected to **identify and quantify these risks** within their overall process of ensuring capital adequacy.
8. Credit risk	In their credit risk management, institutions are expected to consider climate-related and environmental risks at **all stages of the credit-granting process** and to monitor the risks in their portfolios.
9. Operational risk	Institutions are expected to consider how climate-related and environmental events could have an **adverse impact on business continuity** and the extent to which the nature of their activities could increase **reputational and/or liability risks**.
10. Market risk	Institutions are expected to monitor, on an ongoing basis, the effect of climate-related and environmental factors on their current market risk positions, on their future investments and to develop stress tests that incorporate climate-related and environmental risks.
11. Scenario-analysis and stress testing	Institutions with material climate-related and environmental risks are expected to **evaluate the appropriateness of their stress testing**, with a view to incorporating them in their baseline and adverse scenarios.
12. Liquidity risk	Institutions are expected to assess whether material climate-related and environmental risks could **cause net cash outflows or depletion of liquidity buffers** and, if so, incorporate these factors in their liquidity risk management and liquidity buffer calibration.

Main messages from the guide (3/3)

Disclosures

For the purposes of their regulatory disclosures, institutions are expected, to **publish meaningful information and key metrics** on climate-related and environmental risks that they deem to be material, with due regard to the European Commission's Guidelines on non-financial reporting: Supplement on reporting climate-related information.

Disclosure policies and procedures

- Specify considerations for **assessment of materiality** and determine frequency and means of disclosures
- Qualitative & quantitative information underpinning the materiality assessment
- **Methodologies, definitions and criteria** associated with metrics and targets

Content of climate-related and environmental disclosures

- Disclose **financed scope 3 emissions** for the whole group
- **KPIs and KRIs** used for strategy-setting and risk management
- Further environmental disclosures

The ECB Guide: a holistic approach to climate-related and environmental risks

- Embedding C/E risks in all relevant processes
- Involving and empowering all relevant functions
- Promoting resilient business models
- Transparent and regular reporting
- Disclosing meaningful information on sustainability figures, metrics and targets