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 CO₂ in gigatonnes per year)

Warming projected by 2100
Baseline 4.1 – 4.8°C
Current policies 2.8 – 3.2°C
Optimistic policies 2.8°C
Pledges & Targets 2.5 – 2.8°C
2°C consistent 1.6 – 1.7°C
1.5°C consistent 1.3°C

Historical

SSM Risk Map for 2021

Higher

Risk Impact

Disruptive digital innovation and non-bank competition
Repricing in financial markets
Cybercrime and IT disruptions
Increase in misconduct/ML/TF cases
Geopolitical tensions and corresponding outlook impacting supervised institutions
Climate change
Correction in real estate markets
Prolonged economic downturn and increase in NPLs

Lower

Risk probability

Higher

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; “NPL” refers to non-performing loans.

Sources: Climate Action Tracker, Warming Projections Global Update.
Note: December 2019 projections.
SSM Climate Risk Coordination Group (CRCG) chaired by DG-SPL

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

Develop and maintain active dialogue
Establishing a constant dialogue to monitor developments:
- Set expectations
- Industry workshops
- Alignment with NCAs’ work

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

Full alignment with EUCOM, EBA, NGFS and BCBS work and timelines
The ECB is of the view that institutions should take a forward-looking, comprehensive and strategic approach to considering climate-related and environmental risks.
Climate-related and environmental risks (C/E risks) are a key risk driver for euro area banks

Supervisory expectations:

i. Provide transparency about the ECB’s understanding of a prudent approach to managing climate-related and environmental risks.

ii. Enhance the industry’s awareness and preparedness for managing them.

iii. 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
- Governance and risk appetite
- Risk management
- Disclosures

Chapter 4
Business environment & business strategy

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

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

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

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.
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

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

<table>
<thead>
<tr>
<th>Climate-related risk drivers</th>
<th>Potential financial impact</th>
<th>Time frame</th>
<th>Impact on risk profile</th>
</tr>
</thead>
<tbody>
<tr>
<td>Policy and legal</td>
<td>Depreciation of assets of carbon-intensive companies in the investment portfolio</td>
<td>1-3 years</td>
<td>**</td>
</tr>
<tr>
<td>Technology</td>
<td>Corporates involved in the car industry affected by a substitution of existing products and services</td>
<td>3-6 years</td>
<td>*</td>
</tr>
<tr>
<td>Market sentiment</td>
<td>Consumers and investors favouring more sustainable products</td>
<td>1-3 years</td>
<td>****</td>
</tr>
<tr>
<td>Acute physical risk</td>
<td>Damage to property and assets in high-risk locations</td>
<td>1-3 years</td>
<td>*</td>
</tr>
<tr>
<td>Chronic physical risk</td>
<td>Increased costs for customers to address damages or losses caused by climatic incidents affecting their ability to pay</td>
<td>1-3 years</td>
<td>*</td>
</tr>
</tbody>
</table>

Source: ECB.

Observations: banks’ risk management

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

(list of risk management approaches, number of banks)

- Risk identification and measurement processes or tools: 9 in place, 15 not in place
- Climate-related and environmental risks in risk appetite framework: 7 in place, 17 not in place
- Risk management processes for climate-related and environmental risks: 5 in place, 19 not in place
- Stress test and scenario analysis for climate-related and environmental risks: 4 in place, 20 not in place
- Other: 4 in place, 20 not in place
- Quantitative balance sheet targets/exposure limits: 2 in place, 22 not in place
- ICAAP as a specific risk (sub)category: 24 in place

## Observations: banks’ disclosures (1/2)

### Overview of institutions disclosing basic climate-related information

<table>
<thead>
<tr>
<th>Category</th>
<th>Metric</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disclosure policies and procedures</td>
<td>1) Percentages of institutions that substantially consider climate-related risks as immaterial in their disclosures (where the institution reports it deems the risks to be immaterial)</td>
<td>8%</td>
</tr>
<tr>
<td></td>
<td>2) Percentage of institutions disclosing methodologies, definitions and criteria associated with any figure, metric or target reported</td>
<td>45%</td>
</tr>
<tr>
<td>Business strategy</td>
<td>3) Percentage of institutions describing the potential strategic impact of transition risks in the short and long term</td>
<td>30%</td>
</tr>
<tr>
<td></td>
<td>4) Percentage of institutions describing the potential strategic impact of physical risks in the short and long term</td>
<td>24%</td>
</tr>
<tr>
<td>Governance</td>
<td>5) Percentage of institutions describing the board’s oversight of climate-related risks</td>
<td>55%</td>
</tr>
<tr>
<td></td>
<td>6) Percentage of institutions describing the organisation’s processes for identifying, assessing and managing climate-related risks</td>
<td>57%</td>
</tr>
<tr>
<td>Risk management</td>
<td>7) Percentage of institutions describing how climate-related risks feed into credit-granting policies</td>
<td>64%</td>
</tr>
<tr>
<td></td>
<td>8) Percentage of institutions making any reference to the use of scenario-analysis or stress testing</td>
<td>29%</td>
</tr>
<tr>
<td>Metrics and targets</td>
<td>9) Percentage of institutions disclosing at least one metric and one target</td>
<td>37%</td>
</tr>
<tr>
<td></td>
<td>10) Percentage of institutions disclosing a key performance indicator or key risk indicator</td>
<td>26%</td>
</tr>
</tbody>
</table>

*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*: 18%
Observations: banks’ disclosures (2/2)

Chart 8
Has the bank disclosed any climate metric? If so, which ones?

(Percentages)

- Percentage of carbon-related assets in each portfolio
- Carbon footprint of one or more portfolios
- Weighted average carbon intensity of each portfolio
- Exposure of collateral by country of location of the activity or collateral
- Exposure of collateral related to assets in climate change mitigating sectors
- Other
- None of the above

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)
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
Observing the practices of banks’ disclosures

<table>
<thead>
<tr>
<th>Policies and procedures</th>
<th>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. <strong>For those qualifying the risk as immaterial, there is typically no substantiation.</strong> A minority of institutions disclosing metrics and targets appropriately reference methodologies, definitions and criteria.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business strategy</td>
<td><strong>Less than a third of the institutions disclose the potential impact of transition risk on their business model in the short and long term.</strong> 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.</td>
</tr>
<tr>
<td>Governance</td>
<td><strong>Just half of the institutions provide disclosures on either the board’s oversight of climate-related risks or of opportunities.</strong> While some institutions refer to the involvement of the Board in climate-related topics, the form of this involvement is not always described.</td>
</tr>
<tr>
<td>Risk management</td>
<td><strong>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.</strong> 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.</td>
</tr>
<tr>
<td>Metrics and targets</td>
<td><strong>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.</strong> 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.</td>
</tr>
</tbody>
</table>
## Main messages from the guide (1/3)

### Business models and strategy

<table>
<thead>
<tr>
<th>1. Business environment</th>
<th>Institutions are expected to <strong>understand the impact</strong> of climate-related and environmental risks on the business environment in which they operate, in the <strong>short, medium and long term</strong>, in order to be able to make informed strategic and business decisions.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Business strategy</td>
<td>When determining and implementing their business strategy, institutions are expected to integrate climate-related and environmental risks that <strong>impact their business environment</strong> in the short, medium or long term.</td>
</tr>
</tbody>
</table>

### Governance and risk appetite

<table>
<thead>
<tr>
<th>3. Management body</th>
<th>The management body is expected to consider climate-related and environmental risks when developing the institutions’ overall <strong>business strategy, business objectives and risk management framework</strong>, and to exercise <strong>effective oversight</strong> of climate-related and environmental risks.</th>
</tr>
</thead>
<tbody>
<tr>
<td>4. Risk appetite framework</td>
<td>Institutions are expected to <strong>explicitly include climate-related and environmental risks in their risk appetite</strong> framework.</td>
</tr>
<tr>
<td>5. Organisational structure</td>
<td>Institutions are expected to <strong>assign responsibility</strong> for the management of climate-related and environmental risks within the organisational structure in accordance with the three lines of defence model.</td>
</tr>
<tr>
<td>6. Risk reporting</td>
<td>For the purposes of <strong>internal reporting</strong>, 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.</td>
</tr>
</tbody>
</table>
## Risk management

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>7. Risk management framework</td>
<td>Institutions are expected to incorporate climate-related and environmental risks as <strong>drivers of established risk categories</strong> 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 <strong>identify and quantify these risks</strong> within their overall process of ensuring capital adequacy.</td>
</tr>
<tr>
<td>8. Credit risk</td>
<td>In their credit risk management, institutions are expected to consider climate-related and environmental risks at <strong>all stages of the credit-granting process</strong> and to monitor the risks in their portfolios.</td>
</tr>
<tr>
<td>9. Operational risk</td>
<td>Institutions are expected to consider how climate-related and environmental events could have an <strong>adverse impact on business continuity</strong> and the extent to which the nature of their activities could increase <strong>reputational and/or liability risks</strong>.</td>
</tr>
<tr>
<td>10. Market risk</td>
<td>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.</td>
</tr>
<tr>
<td>11. Scenario-analysis and stress testing</td>
<td>Institutions with material climate-related and environmental risks are expected to <strong>evaluate the appropriateness of their stress testing</strong>, with a view to incorporating them in their baseline and adverse scenarios.</td>
</tr>
<tr>
<td>12. Liquidity risk</td>
<td>Institutions are expected to assess whether material climate-related and environmental risks could <strong>cause net cash outflows or depletion of liquidity buffers</strong> and, if so, incorporate these factors in their liquidity risk management and liquidity buffer calibration.</td>
</tr>
</tbody>
</table>
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