MFSA's Banking Supervision Conference

8 November 2023

ESG Risk Management in Banking - Practical Experience and Advice from the EBA

Ladies and Gentlemen,

Let me first thank the Malta Financial Services Authority (MFSA) for their invitation to talk about the management of environmental, social and governance risks in banking from an EBA perspective. I definitely value the opportunity to discuss this complex yet important topic: dialoguing with the industry is absolutely essential for us when developing regulation. I would also like to highlight the very valuable contribution of the MFSA to our work in general.

Today, climate change threatens to fundamentally reshuffle the cards for all of us, which raises the following question: how can we collectively address the major societal challenges posed by environmental, and more broadly ESG risks?

With this in mind, I would like to touch on four main aspects: I would like first to briefly recall what ESG risks are and why they effectively matter for the financial sector and supervisors; then, I will make a few observations on the state of play at banks for dealing with environmental risks. This will lead me to discuss the integration of ESG risks in the regulatory and prudential framework in general; and finally, I would like to particularly focus on the prudential treatment of exposures in the Pillar 1 framework.

Let me start with ESG risks and why they are important.

ESG has become a household topic, but exactly what are we talking about? Rather than new risks per se, ESG factors are (new, or newly identified) risk drivers of traditional categories of financial risks, such as credit, market, operational or concentration risk. And as such, ESG can be a source of financial losses.

Environmental risks (E) are now widely established as being material for the financial sector. This is especially true for climate-related financial risks but also increasingly for nature-related risks, such as biodiversity loss and other environmental degradation or pollution. In fact, the EBA strongly encourages banks to address environmental risks beyond climate, through the analysis of the dependency of their exposures to ecosystem services. Indeed, one should not try to save climate to the detriment of nature! Overall, achieving significant progress on environmental transition and physical risks appears particularly relevant as we approach the 28th Conference of the Parties of the UNFCC "COP 28", which will start in a few weeks in Dubai, as well as the review of Nationally Determined Contributions (NDCs) in 2025, pursuant to the Paris Agreement. Sound environmental risk management is needed as only a robust banking sector can effectively fund the transition towards a sustainable European economy. This is part of the broader endeavor to deliver on the European Green Deal, which aims for carbon neutrality in the EU by 2050.

When it comes to social factors, the EBA considers them to be related to the rights, well-being and interests of people and communities, including factors such as decent work, adequate living standards, human rights, inclusive and sustainable communities, and societies. Social factors can translate into risks for institutions if they have a negative financial impact on the activities of their counterparties or on their assets, and if they tarnish their reputation. While less developed than climate – related risks in terms of framing and available metrics, social risks can also be driven by environmental physical and transition risks, change in policies and/or market sentiment linked to the social transformation towards a more inclusive and equitable society. Developing an EU social taxonomy will provide valuable additional insights, though this will not be a risk classification in itself.

While similar in principle, the analysis of financial losses stemming from governance–related factors has received less attention in recent years. Still, it is an issue that has been identified a long time ago, and which is already supposed to be largely addressed by the current prudential compliance framework! Some examples can be linked to management practices such as independence and inclusiveness, or to corporate behavior, such as transparency, business ethics (bribery, corruption…) or board composition and remuneration. Banks should be already very familiar with all of this, and there is no doubt that these aspects will be further refined in the future.

In short, ESG aspects can be a source of financial risk, and banks must manage them accordingly.

This leads me to my second point: what is the current state of play at banks when dealing with ESG in the banking sector?

Here, I would like to focus on the E of ESG. As mentioned, environmental risks have taken centre stage and, when confirmed, must be properly addressed. The good thing is that this is also an area where financial institution's practices, methodologies and available metrics have been quickly developed. This is especially true for climate–related financial risks. This is also the ESG area most investigated to date by supervisory authorities. Assessments conducted at BCBS or EU level[1] for environmental risks show both progress and need for further advancing current practices.

On a positive note, climate related impacts are now better acknowledged and understood. A high proportion of banks deem themselves materially exposed to climate-related financial risks. For example, as part the of results of the thematic review conducted by the ECB in 2022, *"more than*

[1] EBA 2021 Report on management and supervision of ESG risks ; ECB Results of the 2022 thematic review on climate-related and environmental risks.

80% of institutions" concluded *"that the risks have a material impact on their risk profile and strategy, with 70% seeing material risk within their business planning horizon of three to five years."* Governance and internal control frameworks have been strengthened substantially, and risk management practices are evolving in the right direction. For example, we observe that climate risk drivers are an increasingly part of credit risk management. Of course, collecting granular and reliable data remains a challenge. Nevertheless, banks often use a combination of approaches, relying on targeted questionnaires to their clients, engaging with external data providers or intensifying cooperation with peers and supervisors.

To ensure a prudent management of environmental risks, however, more needs to be done. Banks must continue to strengthen their organisational, risk management and quantitative capabilities. Examples include ICAAP, scenario analysis, risk metrics and indicators. Stepping up efforts to identify data gaps and improve data collection is essential. Furthermore, current practices suggest uneven progress on the incorporation of environmental risk drivers in the management of risk types other than credit. And even for credit risk, many banks are still at an early stage of factoring climate risk into their credit risk models. We showed it with our EBA pilot exercise on corporate exposure in 2021, the 2022 ECB stress test also concluded that credit risk parameters projected by banks showed little sensitivity to climate – related shocks. Important challenges were how to reflect sectoral dimensions, the variable quality of used proxies, and the need to incorporate all relevant climate risk channels (not only carbon price for example). Finally, the consideration of physical risks, nature related risks and biodiversity loss impact remains limited, despite their increasing salience at international and European level.

It is true that assessing environmental risks is challenging for banks due to their emerging nature and limited data availability. This applies to ESG risks overall by the way. However, a range of actions can and should be taken thanks to the metrics and guidance developed in recent years including by the EBA. Firstly, stepping up efforts to identify data gaps and improve data collection, which is essential for risk identification. Secondly, further embedding climate risks in core risk management through risk appetite, internal controls, and assessment of capital adequacy. Upcoming disclosure and reporting obligations, including for non-financial companies, should help them along the way. Now, it is also the case that the public sector needs to be careful not to always add up with new requirements: financial institutions have been given clear directions and tools, we should let them roll these out, look at the result and only then re-assess if necessary.

With this in mind, how can we ensure an effective prudential framework for ESG risks, and what are the actions taken by the EBA?

Embedding ESG risks in the regulatory framework is necessary to achieve an orderly transition to a sustainable economy. This is underway, but it is also challenging. It requires developments on risk management, disclosures, supervisory practices, climate stress testing and enhancements to the prudential framework, as well as work to avoid greenwashing. We published a roadmap on sustainable finance in December 2022, covering all three pillars of the banking supervisory framework and outlining key objectives and timeline for delivering on our mandates[2]. We will complement it with the new mandates stemming from the new EU banking package (CRR3/CRD6) when the final text is adopted.

Let me first briefly touch on transparency and market discipline (or Pillar 3). In 2023 banks began disclosing quantitative and qualitative information following the requirements in the EBA Pillar 3

[2] EBA Roadmap on sustainable finance, published in December 2022

package, with a first reference date of December 2022. This is a first very important step to improve the availability of ESG data – the quality of which is expected to progressively increase - for the benefit of all market participants. Of course, the EBA continues to contribute to the discussion in other relevant fora to ensure consistency and coherence across frameworks.

With better and more consistent data, banks can strengthen their risk management systems to better identify, manage and report ESG risks (as part of "Pillar 2"). This was already flagged in our June 2021 report. To facilitate this, the EBA is updating several of its EBA Guidelines to include ESG risks: this includes EBA Guidelines on loan origination, internal governance, remuneration policies and the supervisory review and evaluation process or SREP. Further, the EBA will receive as part of CRD6 a mandate to issue dedicated guidelines on ESG risk management. These guidelines will allow us to set requirements as to how institutions should account for ESG risks. We expect these requirements to include aspects such as risk appetite, internal controls, ICAAP, management of different financial risk types as well as requirements on transition plans, consistently with other provisions of the EU legal framework. Finally, we plan to update our EBA Guidelines on institutions' stress testing.

Indeed, stress-testing is probably one of the best tools banks and supervisors can use to assess and manage climate risk. Exploring how we can cover climate related risk in the EU-wide stress test is a high priority for the EBA. Luckily, we can draw on a number of initiatives by banks and supervisory authorities for this.

The challenges are well identified and relate to i) limited data and ii) nascent or insufficient methodologies. We had a first go at it in the EBA pilot exercise on climate risks published in May 2021, particularly for client-specific information at the activity level. Moreover, there is a need to develop more comprehensive and forward-looking models and scenarios, covering all specific transmission channels, both for transition and physical risks, having in mind that risks may reinforce eachother.[3]

At the moment, we are preparing a "One-off Fit-for-55" climate risk scenario analysis in collaboration with ESMA, EIOPA as well as the ECB and ESRB[4]. The insight of this unprecedented analysis is its cross-sectoral and system-wide nature, as opposed to standard solvency stress tests which focus on specific financial sectors only. As you know, "Fit-for-55" stands for the EU's target of reducing net greenhouse gas emissions by at least 55% by 2030. The aim of this one-off exercise is to assess the financial sector's resilience in line with this objective, while gaining insights into the capacity of the financial system to support the transition to a lower carbon economy even under conditions of stress. We will investigate how stress may propagate through the financial system and how financial institutions' reactions might magnify it. We will launch the exercise by the end of 2023, with results to be published in early 2025. We do not expect these results to directly feed into the setting of micro-prudential capital requirements. However, they may nurture future considerations on micro and macro prudential policy. Looking further ahead, this will make it easier to carry out a regular EU climate stress test, to strengthen the capacity of banks and supervisors to assess and manage risks in this area.

I mentioned our work on Pillar 3 and on Pillar 2, let me now explain our approach of ESG in Pillar 1.

[3] ECB Results of the 2022 Climate risk stress test, published in July 2022

[4] On 8th March 2023, the EBA received, in the scope of the Renewed Sustainable Finance Strategy of the European Commission the final mandate of the One-off Fit-for-55 climate risk scenario analysis. This can be found at this link.

The key message is that it is guided by risk-based considerations. As you know, article 501c of the Capital Requirement Regulation (CRR) and article 34 of the Investment Firm Regulation (IFR) mandate the EBA to assess whether a dedicated prudential treatment of exposures related to assets or activities associated substantially with environmental and/or social objectives would be justified.

On 12 October 2023, the EBA published a Report on the role of environmental and social risks in the prudential framework of credit institutions and investment firms. It recommends enhancing the Pillar 1 framework to capture environmental and social risks and provides foundations to the future mandates expected from CRR3. This has been a remarkable journey since we published an initial discussion paper in May 2022 with a focus on environmental risks. Since then, we gathered evidence from diverse stakeholders, enlarged the scope to social risks, refined existing approaches and developed new ones.

What principles did we follow? Firstly, we implemented a holistic approach. Pillar 1 is only one part of the overall regulatory framework. This means that other tools (and I talked about them before) are also important – and maybe more important at this juncture – to tackle ESG risks. This includes accounting, pillar 2 requirements, pillar 2 guidance and supervisory stress testing, and macroprudential buffers.

Secondly, we grounded our work in a risk-based approach. This is essential to maintain a robust and evidence-based framework, which ensures the resilience of the financial sector to all risks and its effective ability to finance the transition. In fact, a risk sensitive prudential framework can contribute to channeling funding towards ESG – related investments. Of course, the prudential framework should not substitute to other policy tools, as ESG related externalities primarily lie within the remit of political authorities. This is also essential for acceptability by all stakeholders.

Several challenges and limits were identified along the road. First and foremost, identifying and measuring E&S risks remains difficult due to the existence of data gaps. Moreover, there is still no common standardized and complete classification system. Definitions of what can be considered environmentally sustainable also remain fragmented, and often prove to be binary, making any risk differentiation on their basis difficult. For example, let us imagine a corporate pursuing unsustainable activities but displaying a robust plan for transitioning to a more sustainable business model. How to account for differences in the risk profile compared to a company without such a plan? Ideally, different "shades" of environmental sustainability are expected to be associated with different risk levels.

Further challenges include difficulties in linking non–financial forward-looking ESG information to financial risks and parameters used for prudential purposes, such as probabilities of default ("PDs"). Academic literature has demonstrated in some instances the effects of environmental risk on risk metrics. However, comprehensive changes to the Pillar 1 framework would only be warranted where a clear link between E&S factors and traditional categories of financial risks can be established.

It is therefore of the utmost importance for banks to pursue their efforts on the data side: to develop techniques to identify whether a realized loss is linked to environmental factors as well as assess the extent to which the market already prices in environmental risks. If this is done, then the current form of work already goes a long way to help manage the risk.

One word on a tricky issue: that of adjustment factors. Indeed, it is often suggested to introduce environment-related adjustment factors in prudential rules, mostly in the form of 'green supporting' or 'brown penalising' factors. From an EBA standpoint, such adjustment factors face intrinsic conceptual and operational challenges of plans which would greatly complicate their design and potential implementation. Conceptually, we identify a risk of overlap or double counting with existing Pillar 1 mechanisms. Operationally, we anticipate challenging calibration issues, as well as level playing issues in the absence of international cooperation. Overall, we must ensure that the calculation of risk weighted assets is not distorted and maintain risk–based capital requirements which fulfil their functions of safeguards against unexpected losses. For these reasons the EBA does not support the introduction of such adjustment factors at the current juncture.

Instead, I would like to emphasize that our report makes 38 recommendations to enhance the current Pillar 1 framework: 13 short term and 19 medium- to long term actions.

In the short term, we insist on facilitating and accelerating the recognition of E&S risks integration across pillar 1 while preserving its integrity and purpose. This means improving the capture of E&S risks and favor enhancements rather than introducing dedicated adjustment factors. What does this mean?

- First, to enhance the forward-looking capacity of internal models to capture environmental risks automatically and progressively. We hence recommend stress testing programs under IRB and FRTB-IMA models to explicitly consider environmental risks.
- Further, we encourage the inclusion of E&S risks in external credit assessments by credit rating agencies.
- Due diligence requirements should also explicitly integrate environmental aspects.
- Institutions should account for relevant environmental factors in the valuation of immovable property collateral.
- Institutions should identify whether E&S factors constitute triggers of operational risk losses and progressively develop environment-related concentration risk metrics as part of supervisory reporting.
- Lastly, we recommend to assess how systemic risk buffers could be used to address potential environmental systemic risks.

In the medium to long term, more comprehensive revisions to the Pillar 1 framework should be considered. International cooperation (e.g at the Basel Committee level) will be important. Such actions could rely on a reassessment of risk weights: how E&S risks can be reflected in risk weights for credit risk standard approach, but also in advanced approaches ((i) revising the IRB RW supervisory formula, ii) including under the market risk sensitivities-based method (SbM) a dimension reflecting environmental risks, iii) revising the standardized approach methodology for operational risk). Finally, we would encourage introducing environmental-related concentration risks in the Pillar 1 framework.

The story does not end here though! With CRR3 in sight, our report prepares for the expected future mandates. Firstly, this includes assessing the feasibility of introducing a standardised methodology to identify and qualify exposures, based on a common set of principles to ESG risks classification. In essence, the question is: what is "greenness" from a risk perspective? Useful sources of information could lay in indicators made available by sustainability disclosure frameworks, results from supervisory stress testing or scenario analysis exercise, and possibly certain ESG scoring methodologies.

Secondly, the possible use of scenario analysis will be further explored to enhance the forward-looking elements of the prudential framework. From the Pillar 1 perspective, the use of observed data –most recent data and historical data, where relevant complemented by expert judgement - represents a structural feature of the prudential framework. Despite academic literature showing that some environmental risks are already priced in, most recent data may not yet reflect in full environmental risks due notably to data challenges.

Thirdly, the role of transition plans should be considered as part of the future development of risk-based enhancements to the Pillar 1 framework. Ensuring consistency across legislative frameworks in the EU will be key.

5 / Coming to my conclusion, where does all this lead us?

ESG risks have become a foundational dimension in economic and financial activities. It is not a "feel-good" topic. This is about measuring and managing material financial losses and safeguarding global financial stability considering potentially dramatic environmental and societal changes. This is especially true in the EU with the Green Deal.

Banks have a key role to play in this. Financial intermediaries are there for a purpose (they reduce asymmetries of information), which means that they can be a catalyst. Sound ESG risks management is needed as only a robust banking sector can effectively fund the transition towards a sustainable European economy. Remarkable progress has been achieved in risk management and governance practices, especially regarding climate – related financial risks. However, much remains to be done. It may seem daunting, but in practice, there is a lot of proportionality and gradualism embedded in the regulatory approach.

Last but not least, regulators and supervisors are committed to deliver an effective prudential framework to facilitate this transition. The EBA will continue to strengthen the integration of ESG aspects across all relevant parts of the banking regulatory framework.

So, we are in this together, and I am convinced that we will succeed!

Thank you for your attention.