TRANSCENDENT GROUP INSIGHT

ECB Expectations on Climate Risk Management

In November 2020, the ECB Banking Supervision published a report outlining its expectations on banks for how to address climate-related and environmental risks. Once published, the ECB Banking Supervision asked banks to assess progress against these expectations. The resulting take-away was that if progress continues at this pace, then many banks will not meet expectations anytime soon. So, what are these expectations and what are some of the challenges preventing banks from adequately integrating climate related risks?

Great Expectations

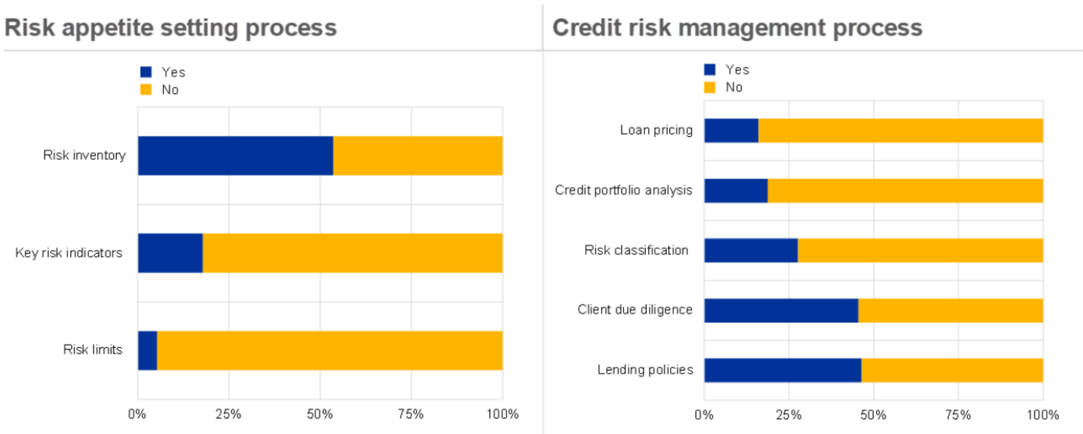
The guide "describes the ECB's understanding of sound, effective and comprehensive management and disclosure of climate-related and environmental risks under the current prudential framework".[1] The table below provides an overview of the key points.

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.
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.
Management body	The management body is expected to consider climate-related and environmental risks when developing the institution's overall business strategy, business objectives and risk management framework and to exercise effective oversight of climate-related and environmental risks
Risk appetite	Institutions are expected to explicitly include climate-related and environmental risks in their risk appetite framework.
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.
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 sub-committees to make informed decisions.

[1] https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.202011finalguideonclimate-relatedandenvironmentalrisks~58213f6564.en.pdf

Risk management framework	Institutions should incorporate climate-related risks as drivers of existing risk categories into their risk management framework, with a view to managing and mitigating these over a long-term horizon. Institutions are expected to quantify these risks within their overall process of ensuring capital adequacy.
Credit risk management	In their credit risk management, institutions are expected to consider climate-related and environmental risks at all relevant stages of the credit-granting process and to monitor the risks in their portfolios
Operational risk management	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.
Market risk management	Institutions are expected to monitor on an ongoing basis the effect of climate-related and environmental factors on their current market risk positions and future investments, and to develop stress tests that incorporate climate-related and environmental risks.
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 into their baseline and adverse scenarios.
Liquidity risk management	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 into their liquidity risk management and liquidity buffer calibration.
Disclosure policies and procedures	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 NFRD.

These expectations are evidently ambitious, and at first glance, it is hardly surprising that the processes of several banks have been found wanting. The notion of managing climate change risks, however, is hardly new. The Task Force for Climate-related Disclosures (TCFD) was established in 2015, producing reporting guidelines aimed at helping companies measure and manage the risks associated with climate change. Interestingly, the feedback the ECB received from practitioners on the risk appetite setting process and the credit risk management process indicate that while climate change is increasingly identified as a material risk, few have fully integrated this into mainstream risk management processes. Whilst more than 50% of respondents had included climate change in their risk inventory, few had implemented risk limits based on climate change risk. Similarly, while several respondents had included climate change in credit risk management processes, few had integrated it into actual loan pricing or credit portfolio analysis.



Source: Preliminary results of the supervisory assessment following the ECB Guide on climate-related and environmental risks.
Note: The blue bar refers to the percentage of banks that had integrated C&E risks in the respective process as at February 2021.

Challenges and Solutions

When working with clients in the banking sector to integrate Environmental, Social and Governance (ESG) risks into risk management processes, there are a few key standout challenges.

Lack of data

Whilst there has been a proliferation of ESG data providers over the past years, most providers rely on the same input, namely the data reported by listed companies through annual reports or reporting frameworks such as CDP. It should also be noted that reporting of climate related risks and KPIs is still voluntary (although this is likely to change with the implementation of the EU Corporate Sustainability Reporting Directive)[2]. For credit portfolios with non-listed entities, company-specific data is almost non-existent, making it difficult to assess, for example, how exposed a company is to transition risk, or the extent to which these risks are being managed.

In addition, as highlighted in the ECB report, climate risk aspects can be included in client due diligence, through a more qualitative approach. Due diligence documentation can be designed in such a way that potential clients are asked to elaborate on potential transition risks that are specific to their industry. Such a qualitative approach highlights another challenge for many banks, namely, employee training on ESG topics and risks.

Training

As a result of the aim to integrate ESG risks into mainstream risk management, ESG-related analysis and considerations are increasingly branching out from dedicated ESG or sustainability departments. Setting the risk appetite would typically be the responsibility of the Chief Risk Officer, ensuring compliance with incoming ESG regulation, as overseen by the Chief Compliance Officer, and assessing the potential risks associated with an investment, as overseen by the corresponding investment team. In many cases, sustainability is still regarded in terms of corporate responsibility, and in working towards minimizing negative impact and maximizing positive impact on the Sustainable Development Goals. Training employees on how to view sustainability topics, such as climate change, as material risks, including how these can be measured, should be a priority for many organizations.

Management buy-in and oversight

The systemic nature of climate-related risks and the significant changes required by organizations to transition to a low-carbon economy means that management buy-in is a pre-requisite for meaningful strategies. In addition, as suggested by the ECB report, status on climate change-related risk exposure should be part of risk management frameworks and internal reporting. It is therefore key, not only to measure climate risks, but to ensure that there are systems in place that can easily track aggregated climate risk.

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[2] https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/corporate-sustainability-reporting_en

Next Steps

The expectations set out by the ECB give a good indication of the direction that climate-related regulation is likely to take in the future. For example, EBA guidelines for loan origination and monitoring already incorporate several ECB expectations, The European Banking Authority (EBA) is currently working on technical standards for the integration of ESG risks in Pillar 3 and in 2022 the ECB will continue to develop stress-tests dedicated to climate risks.

ESG risks, and climate change, need to be treated as material risks that can impact most existing risk assessment categories. While there are still a few challenges to address, the sooner banks begin with this integration, the smoother the process will be.

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