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# Building a regulatory and supervisory framework enhanced for ESG risks

In recent years, the financial sector and policy-makers have stepped up their efforts to tackle risks stemming from environmental, social and governance factors. These, and climate-related risks in particular – raise considerable challenges: their far-reaching impact, irreversibility, and dependency on short-term actions have the potential to materialize into financial risks at many levels and over multiple, including long-term, time horizons. Financial firms cannot ignore these risks. Neither can they underestimate the role they can play in facilitating a transition towards a more sustainable environment.

Traditional risk assessment tools and metrics were not developed to cater for the specificities of ESG risks in the first place. Challenges related to data and methodologies are many. Nonetheless, financial institutions need to build their long-term risk, strategic and operational decision-making processes to embed ESG considerations. The banking regulatory and supervisory framework is actively adapting to integrate ESG factors and risks into disclosure, prudential rules and supervisory practices, at the global, European, and national levels.

The EBA is actively contributing to this, in Basel discussions, but also by directly supporting the EU Commission work, building on the EU taxonomy. It has started embedding ESG risks into the European regulatory framework by following a sequence whereby key metrics and disclosure[1] are available to support strategy and risk management.[2] Enhanced transparency and disclosures of simple and comparable metrics informing on institutions' strategies, such as a Green Asset Ratio, should allow to gradually get to a better picture of the current situation and on the way forward.

In spring 2021 the EBA will publish the findings of its 2020 pilot exercise on climate risk. The outcome of the pilot exercise represents the starting point for a more comprehensive discussion on how to embed climate risk in the stress test framework in the coming years and will support the EBA in shaping methodological aspects and data requirements. While climate risk stress test and scenario analyses differ from solvency stress test in terms of objectives and framework, they can provide valuable information to financial firms institutions for their own assessments of vulnerabilities and the identification of remediating actions.

Stabilizing the referential and its metrics is of the essence if financial firms are to integrate ESG considerations into business strategies, risk management and governance. Any adjustments to prudential treatment will come later, based on appropriate evidence.

Addressing ESG risks requires a long-term forward-looking strategic approach. The ambitious EU sustainable finance agenda paves the way for the development of such an approach, bringing together scientific evidence, societal expectations, public policies, and sound and risk-based prudential standards that take into account the impact of ESG factors and facilitate meeting expectations around financing the transition to a carbon neutral economy. Data and methodologies will keep improving. Some first tools have recently been developed and we can now start implementing them.

[1] See EBA press release

[2] See EBA Discussion Paper