CLIMATE AND SUSTAINABILITY RISKS IN THE BANKING SECTOR

1. The climate change challenge impacts banking sector risk and requires banks to fully play a role

A Central Bank official described how Europe has witnessed several extreme weather events in the past few months and the latest Intergovernmental Panel on Climate Change (IPCC) report concludes that a further rise in temperatures is inevitable. The banking sector must determine how to account for and manage climate risks and ensure that banks remain prudentially sound in doing so. Additionally, banks have a role in financing the transition. New investments will be needed; stranded assets will require disposal; and cleaner energy with lower emissions will need funding. It is important to understand the role of the banking sector in the transition. This role is complementary to the role of governments, which must take the lead in the fight against climate and sustainability risks through subsidies, taxation and pricing. The panel session would focus on three elements: the achievements of the banking system in understanding climate risks and incorporating them into business models; the role of banks in financing the transition and the extent to which tension exists between green innovation and the sector in general; and, finally, measurements and disclosure. Managing climate risks requires a proper understanding of risks and transparency around those risks, which means measurement, valuation, and disclosure are important.

2. Highlights from the preliminary results of a recent ECB survey

2.1 EU banks are beginning to understand the challenges around climate and sustainability

A Central Bank official noted that climate risk is an increasingly urgent topic for banks. The ECB recently conducted a survey of banks in the eurozone. Since European banks do not generally lag in this area, the survey provides a reasonable picture of the global situation. The preliminary results indicate that banks have a growing appreciation of the problem. The survey found that there are people in the banks who care about the issue. The survey demonstrated that banks are in different situations and there is no 'standard' situation. Some banks have developed interesting technical methods for handling these issues, but others are only now discovering their importance. Banks express concern about climate risk, but there are gaps around the technical question of how to transition from this being a concern to understanding how it relates to their business models. The banking sector's business models will have to change as part of a major economic transformation, and most banks have still not done this.

2.2 EU banks must make progress on measuring climate and sustainability related impacts on risk

The Central Bank official described how only 20% of the banks which consider climate as an important issue have begun to review their business models due to a lack of the necessary technical elaboration. To determine how to transform a business model, it is necessary to measure the impact and to understand the economic impact of these drivers on different types of risk, along with distributing the risk among different activities and clients.

2.3 The feasibility of progress is linked to the 'data gap'; there is a need to generalise existing best practices and incentivise clients to provide further data

The Central Bank official noted that banks told the ECB a substantial amount despite there being no regulatory obligation on their part to do so. There is no obligation on clients to provide information to banks. The EU banking sector lacks the data to transform its general concerns into something operational for risk management and governance within banks. The ECB wants to generalise best practices in the industry, because there are best practices for almost everything. Banks can already ask customers for data as part of the Know Your Customer (KYC) process. When a customer asks for a business service, its counterpart can and do ask for data from this customer. This practice could ultimately form part of European regulation, but banks can already do it. The use of proxy measures for client risk could also incentivise clients to engage. If proxy measures suggest that a client is risky from a climate perspective, the bank might limit its operations with that client, what will incentivise the client to provide the information.

Another Central Bank official agreed that the lack of access to data is hampering progress, but the data will never be available if regulators and supervisors do not demand it. The fact that only 20% of banks take account of climate risks is somewhat sobering. The first Central Bank official emphasised that the industry is lagging worldwide. There is good practice everywhere, but it is not sufficiently generalised.

2.4 The mindset gap, the organisational gap and the data gap

An industry speaker explained how the most important element of climate and sustainability risk is uncertainty. This is a new risk, and not much is known about it. The industry must understand how to address climate risks properly, because private financial institutions are facing different kinds of gaps. There is a knowledge gap and a data gap because the industry does not have data for most of its clients. Additionally, there is a gap of in terms of mindset or mentality. The industry is made up of bankers who understand credit risk and financial risk, but they are not prepared for this. Finally, there is also an organisational gap. Banks are organised in siloes but sustainability is extremely transversal. There is a need to ensure the clear integration of this risk within an entire organisation.

2.5 The importance of integrating sustainability components within internal norms, processes and controls and the need to accelerate this process

The industry speaker outlined its financial institution's good progress on climate risk. Financial institutions are 'strange animals', which can be defined as sets of norms, processes and controls. The speaker confirmed its institution is integrating climate risk into its norms, processes and controls using a top-down approach, which is internally known as its 'risk planning processes'. The institution is seeing good progress on risk assessment and in the definition of how climate and sustainability risk impact traditional prudential risk. Currently, the institution is working on developing a risk appetite framework and stress scenario definitions. These scenarios are the best way to quantify long term impact. In terms of bottom up developments, the institution is seeking to integrate this risk management into its credit risk and collateral management frameworks, especially in relation to collateral valuation. The industry understands that there is a challenge around the uncertainty of ESG risk. The stress scenario exercise being conducted by the institution will support its learning process, but this uncertainty means that the exercise will have different data, methodologies, capabilities, and scope. Secondly, there is a challenge around the timeframe. The integration of these risks into financial institutions could have undesirable consequences, and timing will be a key element of managing this process. The support of the ECB guidelines and the work being done by the EBA will assist this process, however. There is also a need to incorporate social risk, the 'S' in ESG, in a much more active way. In particular, it will be very important to integrate Europe's ageing population into the industry's assessment of social risk.

Responding to a query from a Central Bank official about the timeline, the industry speaker suggested that data is the main source of delay. To understand the impact of environmental risk for asset valuation and balance sheet management, there is a need for more data about retail and small and medium-sized enterprise (SME) clients. Data from small clients will be extremely critical. This good quality data will appear in two- or three-years' time, suggesting a timescale of three years for a phase out programme.

3. The banking sector must consider the implications for emerging markets and ensure the transition is a global issue rather than a European one

A Central Bank official moved the discussion to the role of the banking sector in financing the transition. A structural change in the economy requires a new type of asset and new types of companies, which must be financed and funded. This raises questions around how innovative economic activities can fit into the EU banking model. In this regard, there are questions around the stability of the regulatory and legal requirements that affect clients' future performance.

In the context of the role of the banking sector, an industry representative paraphrased Thomas Jefferson: 'Banks are more powerful than standing armies'. While some people might disagree with this, Thomas Jefferson's point is valid in relation to the climate transition, because banks will be central in having a responsibility to be part of the solution to address climate change. To highlight the urgent need for action, the industry representative stressed that the lengths of some careers of bankers and regulators attending the EUROFI conference have been longer than the remaining time available to the 2050 deadline highlighted by the IPCC for meaningful action to be taken to solve the climate crisis. When considering the role of financial institutions, it is important to bring climate and ESG into banks' purpose and strategy in a 'real' way. Climate change and the green transition is the defining risk management challenge and commercial operating opportunity for all bankers. ESG knowledge should be as essential as credit knowledge as part of a banker's core capabilities.

People who work in financial institutions located in Europe must acknowledge their core leadership role in enabling a just transition. There must be climate justice; it cannot be 'just us'. The industry and the world will only be as strong as the weakest link in the climate change chain. The COVID crisis provides an example of what this should not look like. Governments have spent almost 15 trillion on vaccines and support for COVID, largely in developed markets, yet there remains an extremely large adaptation financing gap along with a vaccination gap. There are several ways to ensure a just transition, however. Taxonomies are extremely useful, but the banking sector must consider the implications for emerging markets and trade and capital allocation. Stress scenarios are also an essential tool. The Network of Central Banks and Supervisors for Greening the Financial System (NGFS) has done powerful work on this. When unpicking this type of work, it is important to consider the implications for emerging markets due to the need to drive a properly differentiated and equitable transition. Many banks across the sector are investing in clean or green technological innovations and confirming that firms have the right mindsets while ensuring that emerging markets are being served. Banks are establishing venture and philanthropic funds around clean tech solutions, skills building, awareness and capability building. It will be essential to ensure that emerging markets are properly covered in this regard when funds are being allocated. These are key priorities for financial institutions headquartered in Europe. A Central Bank official agreed that the transition is clearly a global issue. Banks should ensure they include all regions of the world in the transition.

4. Regulatory concerns around climate and sustainability risk

4.1 The full, timely, and consistent implementation of Basel III will ensure the banking system is resilient in the event that the path of the climate transition is not smooth

An official highlighted the global leadership role that Europe has played and continues to play on climate risk. Governments will provide the first and best solution in relation to taxes and subsidies. Banks will complement that, but governments must lead. The official noted that Thomas Jefferson must have been a regulator to suggest that financial institutions are more powerful than armies, given the experience of trying to get Basel III agreed over many years. However, there

is a clear link between the implementation of Basel III and climate risk. The pandemic has demonstrated the importance of bank resilience and the beneficial role that the banking system can play. It is possible that the path of the climate transition will be far from smooth and orderly, which will require the banking system to be resilient from the outset. Banks will need capital and liquidity buffers to absorb large and abrupt shocks. The best way to ensure this is for banks and supervisors to implement Basel III in a full, timely and consistent manner.

4.2 The industry should treat sustainability risk like other material risks

Linked to the idea that the sector should not wait for everything to be perfect, the official stressed the importance of treating climate risk like any other material risk. There are challenges around data gaps and methodological challenges, but the materiality of climate risk requires further investment in risk management processes. This will involve governance, internal controls, risk measurement and management, and understanding how these factors impact credit market liquidity and operational risk. If the data do not exist, this should be done qualitatively. Banks must be able to do their own stress testing and scenario analysis. Ultimately, this will feed through into how banks allocate capital. This will transition to something far more complicated and advanced, but it need not start this way. The Basel framework is broad and requires banks to account for material risk, and climate risk is a material risk. Banks have made considerable progress around supervision, and it is now possible to incorporate climate risk into the Basel framework.

4.3 However, sustainability risk has important specificities which must be factored into banks' approaches to risk assessment and mitigation

The official emphasised that, somewhat paradoxically, the challenges around climate risk also make it unlike any other risk. In addition to data challenges, complexity and global nature of the risk, there are also very long-time horizons, which are not usually considered by bankers and supervisors. The speakers in earlier sessions of the Eurofi conference expressed the implicit assumption that being green is positive for net present value (NPV). The entire industry works on this assumption, but it remains incredibly difficult to make progress on climate risk. While it is true on average, however, there are always large outliers. There will be divergence and heterogeneity in the transition. There will be some significant differences across regions, sectors, and individual entities, and these must be accounted for.

A Central Bank official noted that the official had indicated there was a need to start tackling climate risk immediately even though the process will not be perfect. However, this could lead to the misallocation of capital or resources. If the process is not done correctly, it could lead to polluting industries being financed while green industries are not. The need for progress could create risk around misallocations or banks not properly managing the credit risk connected to sustainability risk. An official agreed, emphasising that, while investing and diverting resources to things that are green will be better, it is important to remember that many green investments will not succeed. Green might be better than brown on average, but there will be risky green investments. The industry must be resilient in general, not only resilient in terms of green versus brown. It is possible to make substantial progress on allocation decisions without having the most sophisticated quantitative model. The industry can make progress on allocating capital by taking those first qualitative steps.

An industry representative explained that climate change and its management is a priority for their organisation. Financial institutions play a critical role in supporting clients' transition pathways and huge investment will be required to implement changes in businesses to ensure sustainability. Such a shift will require funding from not only banks but cross-regional investors. Harmonised disclosure regimes will help ensure relevant risks and opportunities are uniformly understood.

The industry representative's organisation is in discussion with clients about their carbon reduction plans. The financial industry must start work on this and there are three key challenges form them: the pace of transition, assessment of physical risk and the harmonised framework. First, the urgent need to transition should be balanced against the need for continued operations and benefitting the wider economy through increased economic output. Policymakers should consider the broad impact of reforms to determine their feasibility and sufficient implementation period. Climate change is a medium to long-term goal for society, so industries should not be bogged down reactive unreasonable short-termism. Second, physical risk is important for clients. The Japanese government has created hazard maps to prepare for significant natural disasters. These help market participants to quantify their exposure to the physical risk of climate change. Third, a transparent and harmonised global framework will incentivise stakeholders through the transition. EU and global initiatives are underway which aim to resolve existing regulatory fragmentation and divergence in market practice. Their implementation will accelerate the transition and encourage market participants to consider their exposure to sustainability risks. Banks and regulators should act to facilitate reforms.

A clearer, globally aligned standard will help the private sector to implement reforms, because the private sector does business globally. Therefore, the EU should coordinate and accelerate the discussion on a global basis.

5. Challenges around data, definitions and disclosure

A Central Bank official turned the discussion to the question of data, definitions, and disclosure. The EBA has recently done impressive work on disclosure standards, although there are issues with both European and global standards and issues around the quality of those standards.

5.1 The lessons learned from the EBA's EU wide pilot on climate risk

A regulator suggested that his preference would be to be pragmatical, but it is important because the industry will only be able to learn 'by walking'. In the EBA's view,

financial institutions must assess where they are and where they want to be, and then determine whether their path, strategy and business model are consistent with this. In Spring 2021, the EBA published results on credit exposures obtained from voluntary collaboration with 29 banks. Banks are more willing to engage with regulators on climate issues, than in other areas, because both the industry and the public authorities realise they are learning about this together. The 29 banks which participated were large banks in Europe, and they account for 38% of the EU banking sector's exposure. 50% of their corporate exposure, excluding SMEs, is to sectors that are subject to transition risk and 35% of their exposure is in sectors considered high greenhouse gas emitting sectors. The EBA has developed the 'green asset ratio' to understand the percentage of a bank's portfolio that is green. 7.9% of these banks' portfolios were green or involved in what are considered green activities. This is non-financial corporates exposure, excluding SMEs. It is up to each of us to consider these numbers as high or low, but they are the numbers.

5.2 There are significant information gaps around sovereign, SME and household portfolios

The regulator stated that the balance sheets and substantial exposures of banks can be divided into four categories: medium and large non financial corporates, which the EBA's exercise in green exposures cover; sovereigns; SMEs; and retail households. In the latter three categories, there are large information gaps to assess climate risks, and little progress has been made. The work done on retail and SMEs has been poor, and there is very little information regarding sovereigns.

5.3 There are improved prospects for progress on mortgages and SME portfolios

There will be easier progress on households, because their largest exposures are mortgages and there is a substantial amount of information around the energy efficiency of housing and certificates. These could be used on a massive scale. It may also be easier to make progress on SMEs, because it will be possible to apply a simplified version of the risk scoring metrics used to assess medium and large corporates. The topic of sovereigns will be tricker, however, and it is also more sensitive in other ways.

5.4 Banks can further embed sustainability risks in their business models by reporting on the EBA's disclosure implementing technical standards (ITS)

The regulator emphasised the importance of developing concrete proposals for how banks should work on climate risk. The EBA recently issued a consultation on the Pillar 3 disclosure implementing technical standards, which should be approved by the end of 2021. The EBA expects banks to start reporting on this basis by 2023. This is something 'exploratory' for the EBA. Climate risk is challenging for regulators, because they are not used to talking about estimates and ranges for climate risk rather than requesting the reporting of precise numbers. Here, the regulator is seeking quantitative measures for physical risk and transition risk and quantitative measures on banks' mitigation actions. The EBA is asking banks to report on this. This is also done qualitatively by asking banks how they are embedding ESG risks in their governance and business models, which is fundamental to any risk management framework. The EBA is also asking banks to report on their green asset ratios, which has been somewhat controversial. However, this is positive; if it were not controversial, it would probably be irrelevant. There are valid concerns around the misallocation of capital, but here it is important to distinguish between type one errors and type two errors. Type one errors are decisions that prove to be correct but were not taken, and type two errors are decisions that prove to be incorrect. The challenge around climate risk is the danger of making a type one error. The world must ensure that it makes the right decisions and makes progress quickly.

A Central Bank official noted that there are often complaints from the sector about the use of different measurements, systems, and rules. There are differences between European, global and Basel rules. The regulator agreed that there is no single standard across the globe. Basel is a global consensus implemented at a national level. Hopefully, the world will be able to establish a global body, but, in the absence of one, Europe has 'relative leadership' on climate risk. That leadership should not be compromised at the cost of finding a global consensus.

5.5 The development of common language and definitions is essential for the assessment of sustainability risk, despite the challenges around data

An industry representative highlighted the importance of definitions. The terms 'climate risk', 'sustainability risk', 'environmental risk' and 'ESG risk' are often used interchangeably. One step forward would be to develop a common language and nomenclature. The desire for global coordination depends to a large extent on the degree to which participants understand each other and determines the extent of progress that can be made. There is a concept of 'green is good, and brown is bad'. While this is correct on average, it's important to note that the overall picture is more complicated. As innovation occurs, there will be sunrise industries and sunset industries, both of which will carry their own risks. Understanding the interrelationships is important: doing something right sometimes produces unintended consequences. For example, when considering a just transition, an emphasis on thinking about physical risk for the areas being particularly impacted might lead to capital not being allocated to the places which need it most. There is probably more data on the climate risk than in many other areas covered under the umbrella of sustainable risks. Climate change has clear and measurable targets such as the net zero target under the Paris Agreement. However, there is a lack of data and targets for other SDG goals such as gender equality leading to micro issues such as funding gaps in start ups by women founders. If sustainability risk can be systematically linked to targets under the Sustainable Development Goals (SDGs), the data will grow naturally. Scenario analysis and tools are another important priority. It is important to consider the purpose for which scenario analysis is used in climate and environmental risk. Whether it is in business strategy or risk management, those contexts require different types of data and support.