SUSTAINABILITY RISKS IN BANKING

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Banking sustainability risks: central bank and supervisory authority perspective

The transition towards a sustainable growth requires strong commitment by all stakeholders: public and private actors, international bodies and national governments as well as financial regulators and supervisors. Indeed, the financial system can play a key role in such a process. As a central bank and supervisory authority, the Bank of Italy is fully committed to facilitate the smooth development of sustainable finance; as an investor, it has been integrating ESG criteria into its equity investment policy since 2019.

On the banking side, intensive work is underway at national, EU and global levels to assess whether new prudential rules are required to address sustainability risks. In particular, the recent proposal of the European Commission of a review of the Capital Requirements Regulation and Directive aims at strengthening the Pillar 3 disclosure and the management and supervision of ESG risks (Pillar 2), in line with the Sustainable Finance Strategy.

Notwithstanding the regulatory debate is still open, two milestones lead global works for the time being. First, regulation must remain risk-focused: the financial system can play an important role in driving the transition but its success should mainly lie on national governments' responsibilities. Second, climate-related financial risks are nothing but additional sources of well-known risks, which the current regulatory framework seems to be in the condition to manage. However, their distinctive features (i.e. forward looking nature, far-reaching impact, irreversibility) require further analyses to assess whether and how the three Basel pillars could, or should, be enhanced.

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Indeed, filling the data gap and strengthening international coordination are among the main priorities of authorities. The Italian G20 Presidency had a pivotal role to this regard, including the fight against climate change among its top priorities. The Presidency reinvigorated the Sustainable Finance Study Group, which was eventually elevated to a permanent G20 working group; promoted the development of a global baseline for disclosing and reporting sustainability information and climate-related data.

As part of our drive to foster the development of new technologies and sustainable finance, last year the Bank of Italy and the Bank for International Settlements Innovation Hub launched a new G20 TechSprint. This international hackathon received about 250 draft proposals and 99 full applications from teams in 25 countries. The three winners developed innovative applicable solutions addressing the challenges concerning green and sustainable finance.

The impact of sustainability risks on the financial sector still needs to be properly assessed. Relying on the knowledge gained in the economy-wide climate stress test run last year by the ECB and the experience gathered so far, the SSM is launching in 2022 a specific micro-stress test on climate risk for banks under its direct supervision, together with a specific thematic review on risk management practices. Given the data and methodological challenges, both projects will be a learning process for both banks and supervisors.

Environmental risk is a top priority also for the Bank of Italy. We are implementing a pragmatic and gradual supervisory approach, expecting all intermediaries, including small and medium-sized ones, to fully understand the impact of ESG-related risks on their exposures, as well as the threats and opportunities for their business models. As part of a broader thematic review on the governance of Less Significant Institutions (LSI), a first round of targeted interviews to board members of a large sample of banks was conducted last year, in order to gather insights about their degree of awareness towards environmental risk. First evidence shows an increasing awareness in this area, even though material differences across intermediaries still emerge. A more structured thematic review on a sample of LSI will follow in the coming months, as part of an ECB project.

Finally, drawing on the ECB Guide on climate-related and environmental risks, the Bank of Italy will shortly issue a public document containing a first set of supervisory expectations targeted to both LSI and asset managers under its direct supervision, designed according to a proportionality principle.

The journey is still long, especially for smaller players. Banks' vulnerability will depend on a number of drivers, such as business model, sectorial exposure as well as risk concentration. However, it is clear enough that their ability to define new strategies integrating ESG components and targets into the risk management practices and corporate culture will contribute to make their business models more efficient and sustainable in the coming years.

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The prudential treatment of climate-related financial risks: the challenges

There is an absolute need for authorities to review their prudential frameworks as to fully incorporate the implications of climate-related financial risks for financial stability. Physical and transition risks constitute relevant threats to the safety and soundness of individual banks and the stability of the financial system. Accordingly, there is merit in expanding existing prudential regulatory frameworks to ensure that banks have an adequate climate-related risk management processes in place that are consistent with their risk appetite, risk profile and operating environment. In addition, changes to the prudential framework should involve, as the BCBS is envisaging, an assessment of whether capital requirements already adequately capture such risks or if adjustments are needed to address any relevant gaps as to ensure sufficient loss absorbency capacity.

Yet, the operationalisation of such prudential approach for climate-related financial risks entails substantial operational challenges. First, given the longer time horizons and the high degree of uncertainty associated with the materialisation of climate-related financial risks, standard Pillar 1 instruments such as capital requirements might be ill-suited to address such risks. In particular, requiring banks to set aside capital today to cover losses for risks that may only materialise long after the maturity of most of their current exposures and only if their investment strategy remains unchanged over long time-horizons is inconsistent with the construct of the prudential framework.

In contrast, the intrinsic flexibility of the Pillar 2 framework makes it the natural candidate to ensure that banks effectively manage climate-related financial risks and have sufficient loss absorbency capacity against such risks. For examples, supervisors can use scenario anal to increase banks' awareness about potential deficiencies in their risk management framework as well as require management actions and additional loss-absorption capacity, if needed. Having said that, the same flexibility that makes the Pillar 2 framework such a powerful and effective approach may give rise to level playing field issues Guidance on the application of Pillar 2 to address climate-related financial risks would therefore be a welcome development.

Need of a bold response by regulators, but fully anchored on their safety and soundness mandate.

There is no obvious scope for a macroprudential framework aimed at containing systemic climate-related financial risks. First, because the microprudential regime, and in particular, the Pillar 2 framework, through stress tests and scenario analyses, seems to be a more suitable approach to ensure that banks have sufficient loss absorbency capacity against systemic climate-related financial risks. Second, the application of tools such as imposing a capital add-on as a function of aggregate brown exposures are likely to be ineffective and potentially detrimental for financial stability.

Indeed, empirical evidence shows that changes in capital requirements have a small impact on banks' investment policies unless they are calibrated at very large levels. More importantly, macroprudential actions aimed at reducing exposures to carbon-intensive firms and sectors may not always be conducive to reducing aggregate climate-related financial risks. In particular, unlike in the case of standard macroprudential actions, measures aiming at containing brown exposures may not necessarily contribute directly to a financial stability goal, as they might exacerbate transition risks.

Similarly, a green-supporting factor, consisting of alleviating prudential requirements for green exposures is unlikely to contribute to financial stability policy objectives. A reduction in capital requirements for green assets would cause a break in the fundamental relation between risks and capital requirements as there is no conclusive evidence that green investments are less risky than other exposures.

Swift action by governments to steer the transition to a greener economy could fruitfully interact with a financial-stability-focused prudential regulation to ensure an effective contribution by the financial sector to the economic transformation. By deploying a combination of carbon taxes and subsidies as well as guarantees, public authorities should seek to meet that emissions reductions targets and, also, to facilitate an orderly transition to a more sustainable economy.

At the same time, this policy mix would contribute to a reduction in the overall exposure of the financial system to both physical and transition risks. That combined with a well-designed climate-related microprudential framework could make the banking system more able to manage these risks and, therefore, to contribute effectively to the economic transformation.

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Closing the data gaps to allow for an orderly climate risk transition

Financial institutions generally acknowledge the urgent need to take into account the growing importance of Environmental, Social and Governance (ESG) risk factors. Data collected by the EBA show that banks recognise ESG risks as drivers for traditional financial risk categories, credit risk in particular, and start integrating ESG risk considerations into their risk management[1]. However, significant progress remains to be made, including in areas such as business strategies, governance arrangements, risk measurement and monitoring.

Data gaps represent a critical challenge to the development of methodologies to identify, assess and monitor ESG risks. This is fully acknowledged by the public sector. Pro-active actions by banks are also needed, leveraging on available public disclosures, bilaterally engaging with counterparties, and assessing the need to have recourse to external data providers.

Facilitating the transition to a more resilient and sustainable European banking sector is a key objective for the EBA. To that end, the Authority is currently very active complementing the single rule book in the areas of disclosure, supervision, stress-testing and prudential treatment, in collaboration with key stakeholders both inside the EU and internationally.

Firstly, the implementation of a well-defined disclosure ("Pillar 3") framework for ESG risks is needed to facilitate access to meaningful and comparable information, allowing stakeholders to assess institutions' ESG performance and risk profile, and to allow for an orderly transition. The recently published EBA disclosures standards define granular templates, tables and instructions, with quantitative disclosures on climate-related risks and qualitative disclosures on broader ESG risks[2]. These standards can help establish best practices and encourage progress at international level.

Secondly, as reflected in the EBA Report on ESG risk management and supervision, institutions need to further embed ESG risks into their business strategies, risk management frameworks and internal governance arrangements. The EBA expects banks to manage these risks as drivers of financial risks in their risk appetite and internal capital allocation process. The EBA also advises institutions to develop methodologies and approaches to test their long-term resilience against ESG factors and risks, including the use of scenario analysis. Additional guidance was provided with regard to internal governance and remuneration,[3] as well as loan origination.[4] More will come on risk management. Similarly, ESG risks need to be incorporated into supervisory practices.

Regulatory enhancements will best support banks and supervisors in addressing ESG risks.

Climate stress-testing and scenario analyses are also being introduced by banks and supervisors. In 2021, the EBA published the results of its first pilot exercise on climate risk[5], mapping banks' exposures and shedding light on data and classification challenges banks confront. This provided a robust foundation to the work ongoing at supervisory authorities and banks in the area of climate stress tests. The first such exercises will in turn prove very useful to the EBA when embedding climate risk in the EU wide stress testing framework in the coming years, which will also benefit from the work of the Network for Greening the Financial System on climate risk scenarios.

Last but not least, environment risk drivers should also be properly captured into the prudential regime. This should be grounded in measurable facts, as prudential regulation should remain geared towards ensuring the safety and soundness of institutions. A risk-based approach includes assessing whether there is evidence of a risk differential between specific exposures, and whether the peculiarities of environmental risks necessitate to amend the existing rules. The EBA is working on this, and is closely involved in the related Basel Committee initiatives in this area as international coordination is of the essence.

Overall, the materiality of ESG risks is more and more acknowledged and there is a clear willingness of all stakeholders to make progress. While the existing regulatory framework provides a strong foundation for banks and supervisors to address these risks, regulatory enhancements are necessary to best support their efforts and facilitate an orderly transition to a more sustainable economy.

[1] See EBA Risk assessment of the European banking system (December 2021)
[2] See EBA Implementing Technical Standards
[3] See EBA Guidelines on internal governance and remuneration policies.
[4] See EBA Guidelines on loan origination and monitoring
[5] See EBA Report: Mapping climate risk: Main findings from the EU-wide pilot exercise

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International collaboration to ensure sufficient funding for a just transition

Globally, governments, corporations and other market participants are accelerating their efforts to achieve sustainability. Although moving towards the same goal, they are neither moving in tandem nor yet speaking the same language. An example is ESG ratings, where various rating agencies and data providers use different methodologies and definitions to evaluate a corporation. This lack of consistency devalues transparency and provides less meaningful information for investors and other users to assess risk.

A review of sustainability disclosures across Europe and Japan will quickly reveal that although the direction of travel is similar, the pace and approach differs. Most European and large Japanese banks have committed to achieving carbon neutrality or alignment with the Paris Agreement. They have started integrating climate change risks into their governance and risk management frameworks, and have taken steps to conduct scenario analyses. There is wide participation in international initiatives, such as the Net Zero Banking Alliance. However, in areas affected by local government policies, they are taking different approaches. Sector-specific policies, arising out of balancing economic, industry and energy interests, have a significant impact on banks' approaches to transition plans in different jurisdictions.

Climate stress testing is another area that European banks lead, as supervisors have provided clear guidance from an early stage. Japan is currently planning to introduce sustainability disclosure requirements for corporates and considering its supervisory approach to banks' management of climate risks.

As a global bank, our focus is on bridging corporate clients and investors on a cross-regional basis: providing funding opportunities for European corporates by inviting Japanese and other Asian investors, supporting European multinationals to conduct business in Asia, and supporting Japanese companies entering EMEA markets. Those businesses consider the ESG impact of their activities and investments, with transition risks and divergence in the pathways to carbon neutrality across different jurisdictions being key client concerns.

...avoid short-termism and facilitate sufficient funding to achieve a just transition.

Firstly, in respect of transition risk, the energy sector is striving to shift from fossil fuels to renewable energy, which requires unprecedented levels of investment. Transition pathways should be appropriately managed to avoid disruptive events such as commodity price surges. The recent spike in natural gas prices in Europe shows that the world needs fossil fuel energy until there is sufficient investment in renewable energy sources for them to become suitably widespread and reliable. The pace of transition should be carefully managed to balance the drive towards sustainability with ensuring that the associated risks to the economy are properly considered.

Secondly, transition pathways vary both globally, between jurisdictions, and locally, depending on the industry and activities being carried out. There is a risk that capital will flow towards green assets and industries, and although this is desirable in the long-term, in the short-term it will divert vital funding from the industries that need it most, increasing their ESG transition and associated funding risk. Therefore, we urge regulators and policy makers to closely monitor the flow of capital, both locally and globally, to mitigate this risk. As energy transformation requires enormous investment, it is essential that companies appropriately profit from existing business and reinvest for the transition.

The policy measures introduced to meet carbon neutrality targets are intended to facilitate long-term transition pathways to green. However, there is a material risk that some of these could effectively, and unintentionally, function as a penalty and prejudice a just transition. Taxonomy and disclosure requirements will help companies visualise the pace of transition, which may unfairly create a negative impression for companies that have not yet had the opportunity, funding or know-how to transition, or operate in a regulatory environment that has not yet imposed the same measures as the EU.

Achieving carbon neutrality is a universal goal, but implementation is still at an early stage and various challenges remain. Regulators and policy makers should collaborate to ensure a coordinated approach to rule making to reduce global fragmentation, particularly where rules will have extraterritorial effect, so we have a common understanding of our fundamental goals and standards. Even if transition pathways and regulatory frameworks must ultimately differ between jurisdictions due to their varying political and economic sensitivities, the fact is that companies operate globally.

We therefore urge policy makers to ensure that the risks of unintended distortions in the cross-border flow of capital are appropriately monitored and controlled, to avoid short-termism and facilitate sufficient funding to achieve a just transition.

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Greater transparency is key to addressing climate risks for banks

ESG factors can materially influence the creditworthiness of a rated entity when S&P Global Ratings has sufficient visibility and certainty to include them in our credit rating analysis. However, environmental factors currently only have a limited impact on our bank credit ratings because many public policies on climate have yet to take effect. If policy changes are implemented, we expect climate risks to increase over time and believe they could negatively influence the credit ratings of banks most exposed to sectors with significant greenhouse gas (GHG) emissions.

Addressing climate change is a top priority for European governments and policymakers. The EU's Green Deal sets out a path toward a transition. In addition, the EU's Taxonomy, Sustainable Finance Disclosure Regulation, and Corporate Sustainability Reporting Directive are setting new sustainability standards. Regulatory bodies across the world are already working on supervisory frameworks to address climate-related risks for banks, including through the Network for Greening the Financial System (NGFS). European regulators and banks are the most advanced on this front, although the U.S. is catching up rapidly.

For example, the European Central Bank's guide on climate-related and environmental risks released in November 2020 intends to enhance the industry's awareness of and preparedness for managing these risks. At the global level, the Basel Committee's principles-based approach for the effective management and supervision of climate-related financial risks is consistent with the ECB's approach.

The regulatory frameworks applied to banks in their jurisdictions are an important element that S&P Global Ratings considers when we assess their creditworthiness. While the regulatory initiatives listed above are positive developments, most banks have not yet fully integrated climate risks into their risk management framework. In its recent assessment of the most significant eurozone banks, the ECB notes that about half of them expect climate and environmental risks to have a material effect in the short-to-medium term; with credit, operational, and business model risks being the most impacted. Despite that, only a few institutions have put in place climate risk practices in line with supervisory expectations. Integrating climate risks across the full spectrum of risk management activities will require major efforts for banks in the years to come.

Over time, banks will need to navigate the risks and opportunities created by the climate transition.

This will be particularly challenging as banks continue to face several roadblocks in assessing and addressing environmental risks. Disclosures and the quality of data about their customers, especially small and midsize enterprises, are still poor. The risks themselves, which may be nonlinear and have long time horizons, may be difficult to quantify and do not yet have track records. More banks are adopting negative screening policies (such as excluding companies with high carbon intensity) with the immediate benefit of a smaller carbon footprint for their portfolios. However, this breaks the relationship with revenues from these companies and risks are only shifted to another creditor. This is the reason some banks instead prefer to engage with these companies to support their transition. Finding the right balance between these two approaches is an important decision for banks, the results of which might only be known in the long term.

We understand the Basel Committee is exploring the use of the Pillar 3 framework to promote common disclosure standards for climate risks. This positive step would provide investors with more data to compare and differentiate among banks. At this stage, however, we do not expect the Basel Committee to introduce Pillar 1 capital requirements to cover climate risks. We believe this could be possible only with an improvement of data availability and consistency, which will not happen overnight. Also, regulators may proceed gradually because of the consequences any changes might have on the climate transition process of some economic sectors.

We expect supervisors to continue focusing on climate risks. In particular, the ECB's upcoming bottom-up climate stress test may help reveal vulnerabilities of the banking sector, provide greater transparency, and increase the quality and the quantity of data available for our credit rating analysis. For instance, more climate-related data on banks would be useful for our credit loss estimates at both system and individual bank levels. More comparable disclosures of banks' exposures to these risks would also help us further differentiate between banks.

At this point, S&P Global Ratings sees climate stress tests as a valuable first step. However, we recognise that there is significant uncertainty about the pace and impact of climate change, which will be highly influenced by public policies. Over time, banks will need to navigate the risks and opportunities created by the climate transition and adapt their tools, risk appetite, and business models accordingly.

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Sustainability landscape in China

Environment Social and Governance ("ESG") is the essential part of human development, among which the response to environment and climate change is the most urgent and the fundamental challenge for the future. Indeed, this response may dramatically impact the economic development and human being's way of life. It is also recognised that the transition to climate neutrality could create significant opportunities, such as the potential for economic growth and technological innovation.

Many countries and major international organizations have reached the consensus of the need for more concrete efforts for environmental protection, and have over time issued important pieces of legislation and national strategies. EU is playing a leading role in reducing carbon emissions, and responding to climate changes and the protection of the environment. CRD and CRR have set the rules, and ECB and EBA have issued technical standards and guidance. In Luxembourg, the financial sector regulator, the Commission de Surveillance du Secteur Financier has issued Circular 21/773 in June 2021[1] which detailed the expectation for banks to take adequate account of climate and environmental change factors in their strategy, risk appetite, risk management, internal governance etc. As a major channel of financing, banks indeed have an important role to play in addressing environmental and climate changes.

To fulfill its international sustainability obligations, China has set out its "30-60 Targets"[2], which are not only on carbon neutrality goals, but also set the timetable for China's energy revolution. New goals and requirements have been put forward for China's financial industry. The "30-60 Targets" include the following:

The capital market should make adaptation to sustainable development

Mr. Jianfeng MA, deputy director of the China Securities Finance Research Institute of the China Securities Regulatory Commission, pointed out that the disclosure of environmental information by listed companies is of great significance to mitigating climate change, which will help investors to effectively identify green companies and allocate funds to green and low-carbon listed companies. Chinese regulators have continued to strengthen the supervision of listed companies' environmental and social responsibility information disclosure, and are currently formulating measures for listed companies to disclose environmental information in the form of ESG reports.

To fulfill its international sustainability obligations, China has set out its "30-60 Targets".

Financial institutions shall take more actions on sustainable development

From the perspective of regulatory authorities, the China Banking and Insurance Regulatory Commission has put forward requirements for financial institutions' strategic planning to be based on the digital transformation, and green and low-carbon transformation. From the point of view of supervised banks, Mr. Jiandong Liu, Chief Risk Officer of Bank of China Group, said that financial institutions should actively respond to the goals of the state, transform asset allocation, and play a key role in China's carbon neutral vision. Commercial banks need to adjust and optimize asset structure and allocation in combination with their own development strategies. Commercial banks should also conduct stress tests on environmental and climate risks, actively identify and respond to risks, and make adjustments in asset allocation. Carbon emission reduction projects often have problems such as maturity mismatch, higher information disclosure requirements, cost-benefit mismatch, and difficulty in quantifying external effects. Incentives and supporting policies are needed to offset business costs

Introducing a carbon pricing mechanism and improve the top-level design

Mr Zhang Xiliang, director of the Institute of Energy and Environmental Economics of Tsinghua University, said that to achieve the "30-60 Targets", China's energy system needs to undergo a profound transformation. The main measures include the introduction of a carbon pricing mechanism, the setting of floor price/cap trading quantity for the national carbon market, and the floor price level should be gradually increased to shift to a more reasonable and effective price.

In summary, we believe China could learn from the experience of sustainable development in developed economies, China could build a state carbon emission control mechanism and emission trading operation paradigm through carbon pricing. China could promote the formation of technical screening standards for sustainable development and accumulate comparable and reliable database for environmental and climate risk analysis purposes, as well as for meeting climate-related disclosure requirements. Finally to effectively implement the China-EU green partnership, and introduce low-carbon technologies from Europe.

[1] On the management of climate related and environmental riks
[2] China's commitment to hit peak emissions by 2030 and carbon neutrality by 2060