

Sustainability risk

1. Sustainability is not a thing of the past: staying committed despite policy fragmentation and energy market shocks requires more dynamic and agile monitoring without backtracking on objectives

1.1 Energy security and energy affordability are now at the forefront of decarbonisation strategies, but shocks in the energy market make it difficult to predict the direction of the transition

A supervisor framed the panel's scope around rapidly evolving topics — climate, energy and sustainability — set against competitiveness pressures, policy divergence across countries and an accelerating energy transition in many nations.

An industry representative stressed that sustainability is not a thing of the past, but that energy security and energy affordability are now at the forefront of decarbonisation strategies — a reframing MUFG had long anticipated given Japan's energy import dependency. Energy shocks make the direction of the transition increasingly difficult to predict, and the reframing required may come at the expense of certainty. MUFG avoids black-and-white divestment in favour of sector-specific client engagement, planning for a plurality of scenarios that acknowledges the prolonged relevance of transitional fuels. The approach reconciles short-term fossil fuel support with longer-term decarbonisation objectives.

A supervisor highlighted the substantial overlap between energy security and the low-carbon transition in Asia and Europe, while underlining that transition risk encompasses far more than carbon — it includes everything that can go wrong if the transition moves too fast, too slowly, or takes a different course.

1.2 Geopolitical turmoil, growing climate backlash and inconsistent public policies make honouring long-term sustainability commitments increasingly difficult, while stakeholder trajectories are likely to shift

An industry representative observed that while long-term climate objectives remain broadly shared, differences in implementation pathways and policy priorities have produced a more heterogeneous global landscape. External process signals alone cannot suffice, financial institutions must exercise forward-looking judgment in assessing how transition and physical risks affect their portfolios, with risk ownership becoming correspondingly more important.

An industry representative identified three distinct challenges: first, honouring long-term sustainability commitments — some extending up to 25 years — is

increasingly difficult given geopolitical turmoil, the resulting loss of predictability and a growing climate backlash, particularly in the United States; second, stakeholder trajectories are shifting, making adherence to differentiated pathways harder; third, public policies can be inconsistent — on carbon pricing, for instance, or in the growing discrepancy between the omnibus package and supervisors who are simultaneously stepping up their expectations.

1.3 More granular and flexible steering with possible trade-offs is the appropriate response: mission-led institutions maintain their objectives while broadening the focus to the entire environmental pillar, including biodiversity

An industry representative argued that the appropriate response is not to backtrack on objectives but to adopt more dynamic and agile monitoring, with granular and flexible steering that allows for trade-offs as political directions evolve. Where certain targets are not met, this may reflect the legitimate prioritisation of energy security, defence or social spending — not incompatible with sustainability but potentially slowing the pace. La Banque Postale maintains its Paris Agreement alignment target for 2040 and its intermediate targets, while implementing more refined, adaptable monitoring. Beyond climate, biodiversity demands immediate attention across the entire environmental pillar of ESG; establishing relevant risk indicators is difficult, but that is precisely why it cannot be deferred.

A supervisor noted that transition plans may need adjustment given changing circumstances, while observing that European supervisors remain broadly comfortable with the existing framework and have a clear view of what actions to take.

2. Transition risk is not just about carbon: a broadening and interconnected risk landscape demands forward-looking judgment, geographic granularity and clear risk ownership at the institutional level

2.1 From a prudential perspective there is no divergence: banking supervision takes the world as it is, and all risks affecting financial soundness must be managed regardless of whether climate policy remains a political priority

A supervisor was unequivocal: from the ECB's banking supervision perspective, there is no divergence on prudential regulation. All risks affecting the financial soundness of banks must be measured, analysed and

managed — banking supervision takes the world as it is and does not determine non-prudential policy objectives. Those risks do not disappear because a jurisdiction downplays them; the past year's wildfires, windstorms and water scarcity demonstrate this clearly. International cooperation is essential since climate and nature risks transcend national borders. The Basel Committee's 2024 revised core principles and the NGFS's role in developing common frameworks provide an indispensable intellectual foundation.

A supervisor added that clear frameworks facilitate action, and that sharing supervisory observations is the most effective means of maintaining collective momentum and avoiding fragmentation.

2.2 Physical risks, biodiversity and geopolitical exposure are fully interconnected with transition risk — transition and physical risks crystallise differently across portfolios and must be managed jointly through nuanced, sector-specific and geographically granular scenarios

A supervisor clarified that physical and transition risks are fully interconnected and receive equal supervisory attention. Biodiversity is widely misunderstood — it extends well beyond species loss and could significantly affect the EU economy, with internal ECB studies under way. Geopolitical risk adds a further dimension, as recent energy security pressures illustrate. The priority is for supervisors to address these realities as they are and to share practices across jurisdictions.

An industry representative confirmed that for MUFG, managing both transition and physical risks jointly is not new — it is embedded in the institution's DNA given its global footprint. Rather than rebalancing, the focus is on managing both risk types within specific sectors and geographies, given the numerous interlinkages. Physical risks are now materialising in Europe as they have long been present in Japan. Biodiversity scenarios extend to 2100 for physical risk. More nuanced, sector-specific approaches replace uniform scenarios; transition and physical risks crystallise differently across portfolios, and both remain at the forefront.

A supervisor observed that the discussion has become nuanced rather than an either/or proposition, with the requirement for greater granularity varying across sectors and time horizons.

2.3 Transition execution risk is a meaningful forward-looking challenge: ensuring investments required for the transition continue to be bankable, and remaining resilient across a range of possible outcomes rather than assuming a single transition path, demands a different way of thinking

An industry representative stressed that increasing policy divergence — across carbon pricing, industrial policy and regulatory expectations — is reshaping client behaviour and requiring institutions to reassess portfolio composition under greater uncertainty. The appropriate response is to remain resilient across a range of possible outcomes, treating climate as an amplifier of existing risk rather than a separate layer. Sound risk management and clear risk ownership remain essential; more usable

reference points, potentially through the NGFS, are needed to ensure international consistency.

An industry representative introduced transition execution risk as a key forward-looking challenge: ensuring that investments required for the transition remain bankable is becoming increasingly difficult, particularly in the energy sector. Reaching long-term goals may require accepting more risk than is comfortable — a different way of thinking in which mitigation must be weighed against other essential factors. Executing on initial ambitions is a genuine challenge for Europe and for the global transition, especially in Asia.

A supervisor endorsed 'transition execution risk' as neatly capturing the point that transition risk extends well beyond carbon.

3. Current practices remain far below expectations: bridging the gap between ambition and action requires better data quality, a battery of supervisory tools and stronger international cooperation

3.1 An inflation of data volume with little relevance for risk management: a better balance between coverage and quality, an industry-wide approach to SME data collection and greater convergence on Pillar 3 proxies are urgently needed

A supervisor moved the discussion from analysis to action, noting that stress testing, while useful, should not become the sole focus — it is a means to an end and does not replace broader strategic decision-making.

An industry representative identified a fundamental tension between data coverage and quality. The inflation of data in recent years — driven by a tendency to replicate financial reporting — has yielded output largely irrelevant to risk management: the European taxonomy alone requires thousands of cells, few of which matter for this purpose. The omnibus directive has compounded this: banks are still expected to collect data from counterparties no longer obligated to produce it. Three remedies were proposed: using the SFDR revision to strengthen the framework for ESG data providers; an industry-wide initiative to collect SME data in a standardised and proportionate manner; and convergence on Pillar 3 ESG proxies, leveraging the EBA consultation to produce more comparable models.

3.2 The ECB's updated good practices guide, a battery of supervisory tools and emerging cooperation between banking and insurance supervisors aim to reduce implementation gaps and share experiences across jurisdictions

A supervisor expressed the ambition that the ECB's forthcoming updated good practices guide — reflecting six years of supervisory experience — will serve as a genuine facilitating resource. Nature and climate risks are growing faster than expected, and portfolio-level

granularity is now essential, yet is relatively new for the banking sector. Water scarcity illustrates the interconnected effects, affecting agriculture, nuclear plants and AI data centres alike. The ECB is developing a battery of tools to achieve a more comprehensive view of risks affecting financial soundness. International cooperation is more crucial than ever, given the absence of historical data for this category of risk.

An industry representative raised the question of financial conglomerates mixing banking and insurance activities, noting the link between sustainability and insurability and the potential for complementarity in enhancing data quality and risk management.

A supervisor confirmed that climate risk affects all financial sectors equally. The ECB-EIOPA paper on potential public-private schemes represents early but important coordinated thinking; integrated entities may face specific questions even where their portfolios differ.

3.3 A gradual, risk-based and internationally consistent approach, with NGFS and JFSA sectoral guidance as common reference points, should strengthen financial stability rather than complicate it

An industry representative highlighted the role of the NGFS and TCFD frameworks in building the analytical basis for climate-related work. Where quantitative

metrics are unavailable, qualitative information can bridge gaps, and institutions should be allowed to identify exposures while methodologies develop. A gradual and proportionate approach is appropriate: as data improves, supervisory expectations can evolve on a more solid basis. A risk-based, internationally consistent and operationally credible approach is essential to ensure improved comparability of climate risks and to strengthen financial stability rather than complicate it. Japan's FSA has operationalised this through sectoral guidance providing a common reference for banks and borrowers to design transition plans towards 2030, 2050 and net-zero targets, tailored to each sector's specific carbon positioning.

A supervisor concluded that commitment remains high, reinforced by the overlap between today's pressing challenges and the transition agenda. The discussion is maturing — more granular, specific and detail-oriented. Data is the essential foundation, but action cannot wait for full availability. The interdependencies between climate and nature, short and long-term horizons, and the respective roles of policies, supervisors and institutions make the landscape more challenging to navigate; but a clear analytical framework exists, and progress is both possible and imperative.