Increasing supervisory focus pushes climate risk onto bank credit agenda

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Banks need to develop comprehensive and forward-looking approaches to climate-related risks. Regulators globally are increasingly focused on the risks to financial stability posed by environmental factors and are developing their expertise and urging banks to assess them. Guides and best practices are being published and supervisory expectations and guidelines have been articulated. Mitigating climate-related risks is not currently part of the prudential capital framework but this could change in the future.

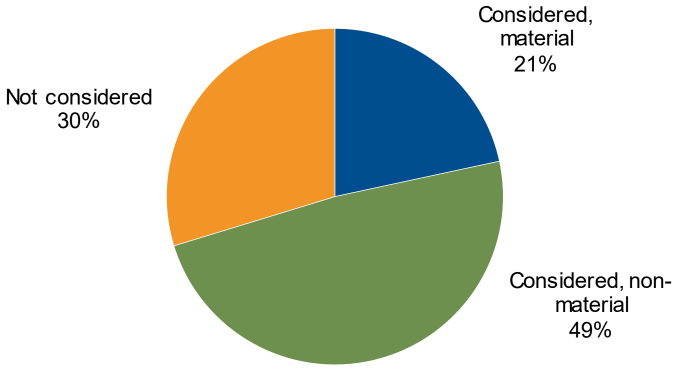
Scope is focused on assessing how ESG factors might impact an issuer's creditworthiness and ability to repay debt. Due to the increasing attention of supervisors on environmental factors, this is becoming a relevant part of bank credit analysis. However, climate-related disclosures are generally insufficient for our purposes. Recent comments from regulators confirm the need for banks to improve management and disclosure of climate-related risks.

Disclosures must demonstrate that a bank is not just aware of the risks but is taking action to manage them. The combination of detailed supervisory expectations, the development of best practices, and efforts to mainstream reporting on ESG indicators will help in this regard. Importantly, the drive for greater comparability and consistency in reporting applies not only to banks but to their counterparties, which should aid banks in their assessment and management of climate-related risks. Notable efforts include the Task Force on Climate-related Financial Disclosures (TFCD) framework and the common metrics and consistent reporting framework developed by the World Economic Forum and the Big Four accounting firms.

Climate-related risks not consistently managed

Based on a recent review of internal capital adequacy assessment processes (ICAAPs) submitted by a sample of 37 significant institutions[1], the ECB concluded that the vast majority of banks do not have processes in place to systemically identify and manage climate-related risks. Consequently, these banks continue to make uninformed business decisions and expose themselves to risks that may materially impact capital adequacy in the medium to long term. Further, the ECB highlighted that almost one-third of banks had not considered climate-related risks at all in their risk identification processes.

Figure 1: Not all EU banks assess climate-related risks



Source: ECB, Scope Ratings.

[1] ECB report on banks' ICAAP practices, August 2020.

Most often considered an environmental and social risk

Banks most often included climate-related risks as part of environmental and social risk or sustainability risk. Few considered climate-related risk a separate risk category. When climate-related risks were considered in risk management processes, one-third of banks classified these risks as being material. The ECB highlighted, however, that the criteria used to determine materiality were not well elaborated and when concrete criteria existed, they were often qualitative in nature.

To manage their exposure to risks, one in five banks used climate-related indicators such as limits on total carbon intensity to perform negative screening. Few banks included climate-related risks in their stress testing, and the practice of assessing the impact on capital and capital requirements is limited.

The ECB's findings are not dissimilar to those from the Bank of England's survey of the UK banking sector in 2018. It found that the approach to the management of climate-related financial risks varied widely between banks: 30% viewed climate change primarily as a corporate social responsibility and another 60% assessed climate change as a financial risk focusing on a three to five-year time horizon. Only 10% were taking a strategic, forward-looking approach driven by the long-term interests of the firm.[2]

Supervisory expectations are quickly evolving

Expectations for governance, processes, and risk management

The Bank of England has since detailed its expectations for banks and insurers to take a strategic approach when addressing financial risks associated with climate change[3]. These supervisory expectations cover governance, risk management practices, the use of long-term scenario analysis for strategy setting and risk assessment, and disclosures.

The planned stress test exploring financial risks from climate change has been postponed to at least mid-2021, but the Prudential Regulatory Authority (PRA) has clarified that banks should fully embed their climate-change risk management approaches by the end of 2021.

UK banks: more needs to be done by end-2021 deadline

In July 2020, the PRA stated that most firms were making good progress with their implementation plans but improvements were still required to meet its expectations:

- Strategic responses need to be clearer, accompanied by the development of tools to inform business decisions.
- Oversight of climate-related financial risks could better incorporate the breadth and magnitude of the risks.
- Reasonable proxies and assumptions should be used when the science, data or tools are not sufficient to estimate risks accurately.
- Risk management processes are at an early stage of development. Few firms have implemented integrated policies, thresholds, mitigation strategies, monitoring capabilities and risk appetites.
- Scenario analysis capabilities must be materially improved. There are significant gaps in capabilities, data, and tools.
- Climate-related disclosures are limited by firms' capabilities and hence these need to materially improve to facilitate future disclosures.

[2] PRA, Transition in thinking: The impact of climate change on the UK banking sector, September 2018.
[3] PRA, SS3/19: Supervisory statement on enhancing banks' and insurers' approaches to managing the financial risks from climate change, April 2019.

EU banks: to be part of supervisory dialogue

In May 2020, the ECB published a guide on its expectations for banks to prudently manage climate-related and environmental risks and to disclose such risks in a transparent manner[4]. Although not legally binding, the expectations went into effect immediately and will form a part of the supervisory dialogue. Further, the ECB will consider any practices diverging from its expectations on a case-by-case basis from end-2020. For less significant banks, national competent authorities are recommended to apply the expectations in a proportionate manner.

With such wide-ranging and comprehensive supervisory expectations (13 in total), few banks will escape the need to devote management attention and resources to developing their capabilities in this area (see Appendix). Of note, risks need to be considered over short, medium, and long-term time horizons. As well, risks are expected to be identified, quantified and stress-tested to ensure capital adequacy and appropriate liquidity management and buffers. Further, responsibility for the management of risks should be along the three lines of defence model.

Disclosures are a key part of supervisory expectations

In addition to existing requirements to disclose material risks in Pillar 3 reports under the Capital Requirements Regulation (CRR), the UK's PRA expects firms to consider making climate-related financial disclosures in line with the TCFD framework and other initiatives. Meanwhile, the ECB expects banks to publish meaningful information and key metrics on climate-related and environmental risks deemed to be material, as a minimum in line with the European Commission's Guidelines on non-financial reporting: Supplement on reporting climate-related information, which are based on the TCFD's recommendations.

Further, from 28 June 2022, large institutions which have securities trading on a regulated market of any EU member state will need to disclose information on ESG risks, including physical and transition risks (CRR 2, Article 449a). These will form part of Pillar 3 disclosures.

Current Pillar 3 reports contain limited ESG risk disclosures

In an assessment of Pillar 3 disclosures[5], the EBA found that disclosures on ESG risk are scarce and presented in a dispersed way. Out of a sample of 12 institutions, three were commended as they had already identified ESG-related risks in their Pillar 3 reports, whether environmental risks linked to credit risk, emerging risks with an impact on the institution's strategy or operational and reputation risks. Some banks have stated their intention to implement disclosures recommended by the TFCD.

Further disclosure requirements are likely to come from the European Commission's (EC) review of the Non-Financial Reporting Directive 2014/95/EU (NFRD). Two consultations have been held this year to consider a new regulatory approach to non-financial reporting. The aim is to improve disclosures on climate and environmental data and to give effect to changes required by the new Disclosure Regulation on sustainability-related disclosures in the financial services sector and the upcoming Taxonomy Regulation on sustainable activities. The EC is expected publish draft legislation on changes to the NFRD in the fourth quarter of 2020.

Enhanced ESG risk disclosures required under NFRD

The NFRD requires companies with more than 500 employees to include on an annual basis disclosures related to sustainability such as environmental matters, social and working conditions, respect for human rights, and anti-corruption and bribery. As the directive has been transposed into national law, several countries have added additional requirements. Companies must report on the business impact, relevant risks and include non-financial KPIs. If no guidelines related to sustainability are in place, a company must

[4] ECB, Guide on climate-related and environmental risks, May 2020.
[5] EBA report on assessment of institutions' Pillar 3 disclosures, March 2020.

explain why. As the NFRD requirements apply to both banks and companies, these disclosures will provide an important input for banks as they identify, assess, and manage the climate-related risks they are exposed to in their lending activities.

In June 2019, the ECB published non-binding guidelines on climate-related disclosures with specific guidance for banks and insurance companies. This included an illustration of how TFCD recommended disclosures could be mapped to NFRD disclosure requirements (Figure 2).

Figure 2: Mapping of NFRD disclosure requirements to TCFD recommended disclosures

TCFD Recommended Disclosures		NFRD Elements				
		Business Model	Policies and Due Diligence Processes	Outcomes	Principal Risks and Their Management	Key Performance Indicators
Governance	a) Board's oversight		■			
	b) Management's role		■			
Strategy	a) Climate-related risks and opportunities				■	
	b) Impact of climate-related risks and opportunities	■				
	c) Resilience of the organization's strategy	■				
Risk Mgmt.	a) Processes for identifying and assessing				■	
	b) Processes for managing				■	
	c) Integration into overall risk management				■	
Metrics & Targets	a) Metrics used to assess					■
	b) GHG emissions			■		
	c) Targets			■		

Source: European Commission.

Guidance for banks on how to make meaningful disclosures

Good disclosure on how risks are managed can set a bank apart

Good disclosure can demonstrate that a firm is aware of the risks and is taking action to mitigate and/or reduce them. Information that helps investors to assess whether a firm, its business model and revenues will remain robust as climate change scenarios play out are increasingly being called for.

In addition to the efforts of supervisors and regulators, industry-led forums are developing practical tools and recommendations to aid firms in their responses to climate-related financial risks. One such example is the Climate Financial Risk Forum (CFRF), which comprises senior representatives from banks, insurers, asset managers and trade bodies in the UK and is co-chaired by the PRA and the FCA.

As part of its work, the CFRF has produced suggested metrics that banks can consider reporting on an annual basis to meet the needs of various users of disclosures (Figure 3). They are based on good practice examples from industry as well as guidelines set by industry bodies. We note the relatively high level of detail and specification in the suggested disclosures (Figure 3).

The CFRF has also produced guides providing examples of good practice and case studies to illustrate how to embed climate change into existing risk management processes and how to use scenario analysis to assess climate-related financial risks to inform a firm’s strategy, risk management and business decisions.

Figure 3: Examples of suggested disclosures relating to risk analysis for banks

Category	Suggested metrics	Purpose
Transition risks & opportunities	**The following metrics may apply to the firm's banking books, trading books and debt and equity underwriting activities (referred to as the 'portfolio').**	
	Basic	
	• Proportion of portfolio[34] with exposure to companies with fossil fuel revenues[35 36]	• Indication of awareness of transition risk exposure; indication of transition risk exposure of existing portfolio
	• Proportion of product held in low carbon opportunities[37]	• Indication of awareness of transition opportunity exposure; indication of transition opportunity of existing portfolio
	• Quantitative, scenarios-based impairment metrics developed using a range of scenarios (e.g. carbon prices or transition pathways) including potential impact on revenues, costs and asset values	• Indication of quantified financial exposure to risk and opportunity
	• Portfolio warming potential of portfolio in °C	• Indication of an awareness of adverse impacts generated by existing portfolio
	In addition to disclosing metrics on the products that they manage, banks should report on the greenhouse gas emissions (scope 1 and 2) arising directly from their own operations.	
Physical risks	**Stretch**	
	• Proportion of portfolio highly exposed to key indicators of physical risks e.g. mortgages secured on property in 100-year and 200-year flood plains, according to the bank's prioritisation of risk, by geography/sector	• Indication of concentration of risk in existing portfolio
	• Credit risk exposure of portfolio in relation to key indicators of physical risk, according to the bank's prioritisation of risk, by geography/sector	• Indication or concentration of risk in existing portfolio
	Advanced	
	• Quantitative, scenario-based impairment metrics (e.g. using forward looking, location-specific models describing environmental hazard) including potential impact on revenues, costs and asset values	• Indication of quantified financial exposure to risk

Source: Climate Financial Risk Forum.

Regulators globally include climate-related risks in monitoring of financial stability

Two-fifths of regulators globally have or are issuing guidance

In a survey performed by the Basel Committee on Banking Supervision (BCBS)[6], almost all members had conducted research on measuring climate-related financial risks and had raised risk awareness with banks through public channels. Further, approximately two-fifths of members have issued, or are in the process of issuing, principles-based guidance to banks related to the governance, strategy and/or risk management of climate-related financial risks. Notably, several jurisdictions consider the Pillar 2 framework to be sufficiently flexible to address these risks. ICAAPs should capture material risks not sufficiently covered under Pillar 1, and such risks could include climate-related financial risks.

In another survey undertaken by the Financial Stability Board[7], over 70% of respondents are currently considering, or planning to consider climate-related risks in their financial stability monitoring. Of these, the focus on physical risks is somewhat greater than on transition risks; possibly due to the greater availability of data on the manifestation of physical risks (e.g. the incidence of extreme weather events) compared to the greater complexity of estimating the scale of transition risks.

Stress tests at bank level are being developed

To-date, top-down analysis of climate-related risks has been more prevalent. However, there is a growing interest in bottom-up analysis where financial institutions determine estimates of risks themselves based on common scenarios provided by financial authorities.

In Europe, the Bank of England and the Banque de France/Autoritė de Contrôle Prudentiel et de Rėsolution (ACPR) are taking the lead in this respect. The BoE’s upcoming stress test involves three scenarios with 30-year modelling horizons and captures different combinations of transition and physical risks depending on assumed policy actions. The UK’s largest banks and insurers will be required to undertake granular analysis of the vulnerability of individual counterparties’ business models in each of the scenarios – covering 80% of corporate exposures and at the household level for household exposures.

The Banque de France/ACPR are currently conducting an exercise to assess financial firms’ exposures to climate-related risks. Based on reference scenarios from the Network of Central Banks and Supervisors for Greening the Financial System (NGFS), the framework disaggregates the GDP impact of simulated shocks (through a carbon price and productivity variables) on 55 sectors of the economy and associated asset prices.

[6] BCBS, Climate-related financial risks: a survey on current initiatives, April 2020.
[7] FSB, Stocktake of financial authorities’ experience in including physical and transition climate risks as part of their financial stability monitoring, 22 July 2020.

Appendix: Overview of ECB supervisory expectations on climate-related and environmental risks

1.	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.
2.	When determining and implementing their business strategy, institutions are expected to integrate climate-related and environmental risks that materially impact their business environment in the short, medium, and long term.
3.	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.**
4.	Institutions are expected to explicitly include climate-related and environmental risks in their **risk appetite framework**.
5.	Institutions are expected to assign responsibility for the management of climate-related and environmental risks within the organizational structure in accordance with the **three lines of defence** model.
6.	For the purposes of internal reporting, institutions are expected to report aggregated risk data that reflect their exposures to climate-related and environmental risk with a view to enabling the management body and relevant sub-committees to make informed decisions.
7.	Institutions are expected to incorporate climate-related and environmental risks as drivers of established risk categories into their existing risk management framework, with a view to managing and monitoring these over a sufficiently long-term horizon, and to review their arrangements on a regular basis. Institutions are expected to identify and quantify these risks **within their overall process of ensuring capital adequacy**.
8.	In their credit risk management, institutions are expected to consider climate-related and environmental risks **at all stages of the credit-granting process and to monitor the risks** in their portfolios.
9.	Institutions are expected to consider how climate-related events could have an adverse **impact on business continuity** and the extent to which the nature of institutions activities could increase **reputation and/or liability risks**.
10.	Institutions are encouraged 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-testing scenarios** that incorporate climate-related and environmental risks.
11.	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.
12.	Institutions are expected to assess whether material climate-related and environmental risk 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.**
13.	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, as a minimum in line with the European Commission's Guidelines on non-financial reporting: Supplement on reporting climate-related information.

Source: ECB

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