Banks' climate risk must become a prudential risk

Credit investors are focusing increasingly on climate-change (CC) and environmental risks as essential investment drivers. But when it comes to assessing bank risk, these non-financial aspects are not yet on the front burner like they should be. Because despite more comprehensive supervisory guidance, CC risks are not part of banks' prudential risk regulations and metrics.

This does matter, because on banks credit investors and analysts take their cue from regulators – what they say and what they do. Especially since the last crisis. Banks' defaults on their debt obligations are the result of some extreme regulatory action: early intervention (for capital securities), resolution, or liquidation. Anticipating supervisors' reactions to, say, a bank's sharp hike in loss provisions or a sudden drop in asset values is essential in the credit assessment of banks. And while CC risks are increasingly being scrutinised, they have not yet found their way onto regulators' prudential risk map. A bank falling behind peers in CC adjustment expectations would have time and be encouraged to catch up. A bank with prudential metrics falling below requirements will likely be in more immediate trouble.

To be sure, there is heightened pressure on banks to take CC risk and other ESG factors into account when formulating and implementing their lending and investment activities. The pressure comes from politicians, regulators, investors, customers, counterparties and the media. And it of course also results from the banks' evolving corporate culture and goals. But the market assessment of banks' approach to CC risk is still at an early stage of being shaped up, and thus remains relatively de-linked from the mainstream analysis of financial risk and return. Stakeholders can assess and compare banks' corporate social responsibility policies and statements, but it is more difficult to pursue credit analysis much beyond that in the absence of standardised disclosure, metrics and regulatory imprimatur. As for the equity side, there are attempts to incorporate ESG criteria into bank stock-pricing models, although their accuracy has yet to be vetted.

That being said, more and more European banks are making good progress in CC risk disclosure. Properly calibrated external ESG scores[1] can certainly add value. Also, supervisors are providing more guidance on the topic. But guidance is not the same as regulation. The element that would link CC and environmental risks to credit assessment by investors will be their inclusion in prudential risk regulations. This will be not a moment too soon.

Prudential regulation for climate risk is necessary but still premature…

Last May, the Network for Greening the Financial System (NGFS) – a fast-growing network of central banks and supervisors (a "coalition of the willing" established in December 2017 and including 66 members and 13 observers) – published three technical documents: a guide for supervisors for integrating CC risks into prudential supervision, a guide to climate scenario analysis, and a status report on financial institutions' focus on green, non-green and brown assets[2].

NGFS provides five CC and environmental risk-related recommendations which should in time help financial supervisors carry out this essential mandate. These recommendations are not binding but aim to contribute to developing an international approach that is relatively harmonised.

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[1]Such as MSCI, Sustainalytics and a few others. In this context the 'new kid on the block' is Scope's ESG impact analysis and scoring methodology, launched last week. The methodology, drafted by my colleague Diane Menville, incorporates the ESG impact on the entire supply chain, assigns a monetary value to it, and relies on publicly available data to avoid potential company-disclosure biases. https://www.scoperatings.com/#!search/research/detail/164212EN.
[2] https://www.ngfs.net/en/liste-chronologique/ngfs-publications

The documents highlight that, with respect to CC, physical risks can affect financial entities through extreme weather events and gradual shifts in weather patterns. As for transition risks, the transmission channels are:

(i) climate-related mitigation policies (e.g. introduction of carbon pricing leading to 'stranded' assets[3]);
(ii) technological advances (e.g. leading to new energy sources which displace older alternatives);
(iii) shifts in public sentiment, preferences and expectations (e.g. increased litigation against carbon-intensive sectors).

The documents point to major challenges in adding granularity – thus better accuracy – to the data; in dealing with the very long timeframe (30 years); and the lack of proper comparability.

In the absence of clear relevant back data, NGFS recommends that supervisors develop and rely on scenario analysis and encourage supervised entities to do the same. That, however, is easier said than done, as uphill challenges exist, when climate scenarios are chosen, in assessing economic and financial impacts of these scenarios. Most available scenarios are too theoretical for supervisory use, and the evolution of carbon dioxide removal technologies can alter the dynamics of the transition. Meanwhile, the economic models typically used by central banks make them ill-suited to study CC, again not least due to the lengthy timeframe of the latter.

The green vs brown debate is equally less than conclusive. NGFS cites the example of palm oil, which can be categorised as either green (as it can replace aircraft fuel) or brown (as plantations can lead to deforestation and monoculture issues). While the recently adopted EU taxonomy should help European supervisors, global comparability is more difficult due to the existence of alternatives like the Chinese taxonomy.

Consequent to these inherent limitations, it is at this time unrealistic for regulators to contemplate including CC parameters in prudential metrics. Some interested observers, like the European Banking Federation (EBF), are pushing for outright capital reductions to support sustainable finance. This is more problematic than it looks, though – something the EBF itself admits. From a prudential angle, the data doesn't support a lower PD for a green credit exposure than for a non-green exposure. The EBA hopes that following a thorough analytical process it will be able to provide a recommendation on dedicated prudential treatment of exposures associated with ESG objectives by 2025.

With respect to banks' capital requirements under the EU's Supervision and Examination Process (SREP) framework, CC-related prudential adjustments could occur in the business model and governance/risk management modules. In these instances, the prudential supervisory judgment could be more of a qualitative aspect rather than primarily quantitative. For instance, the impact of a bank's business model on climate and environment, or proactively including CC risks in the risk assessment framework. Examples of the former include avoiding corporate lending that could lead to stranded assets or focusing on mortgages for energy-efficient houses. Higher scores for these modules on account of an effective push into sustainable lending could end up having positive consequences for SREP capital requirements.

In addition, once more clarity exists about green vs brown, identifying banks that display higher green-asset ratios (e.g. 60%-70% vs the 25%-30% currently assumed on aggregate) could count for their Pillar 2 requirements, alongside other factors.

… Although supervisory guidance is broadening

Supervisory focus on CC and environmental risks has been increasingly intense this year, both before and during the pandemic. It is fair to assume that it will not slow down. On the contrary. Existing guidance aims to provide a framework for the management and disclosure of ESG risks.

The EBA claims to have taken a lead role in this area, reflecting its new responsibility to incorporate ESG factors in its activities and decisions. One area of focus is banks' need to include ESG factors in their Pillar 3 disclosure, which will be mandatory from 2022. Those will include CC-specific elements, such as scope 3 greenhouse gas (GHG) emissions. These are particularly important for banks, as they include all indirect GHG emissions that occur in the value chain of reporting companies, both downstream and upstream emissions. Over the next few years, the EBA aims to increase its ESG supervisory guidance for banks, as both the ECB and other EU supervisory authorities expect it to be able to assess how ESG risks can be incorporated into prudential norms.

[3] NGFS quotes an independent study which estimates that economic losses in case of delayed mitigation policies could reach USD 20 trillion.

Last April, the three European supervisory authorities – EBA, ESMA and EIOPA – published a joint consultation paper on ESG disclosures[4], addressing a financial institution's due diligence policy in respect of the adverse impact of investment decisions on sustainability factors. The disclosure template draft lists the 32 required adverse ESG sustainability indicators, including those related to climate – carbon emissions, footprint, weighted average intensity, and solid fossil fuel exposure. The paper considers that both physical and transition CC risks should be considered drivers of prudential risks (credit, operational, market, and liquidity). Recognising that these risks are likely to materialise over the long-term, it guides nonetheless to a more immediate tackling of them by banks.

As for the ECB, in late May it published a draft guide on climate and environmental risks[5], detailing its 13 key supervisory expectations related to their identification, assessment, governance, management and disclosure. These are not meant as prudential norms, only as a basis for a dialogue with the supervised institutions. They represent a broad indicator of the future supervisory framework of the euro area's Single Supervisory Mechanism (SSM) for banks.

Some national supervisory authorities are also taking a leading role in CC risk identification and management by banks. Notably France, UK and the Netherlands, which were among the first bank supervisors in Europe and in the world to focus on CC risk for banks[6].

Following up on earlier steps, the French financial supervisor Autorité de Contrôle Prudentiel et de Résolution (ACPR) will later this year undertake a pilot exercise on how the French banks and insurers can integrate CC into their risk management. The exercise, which promises to be interesting, will be highly granular (55 sectors) and will look at four geographic areas for the exposures (all voluntarily submitted by supervised entities): France, the rest of Europe, US, and (for significant exposures only) other regions. Because of the 30-year time horizon of the exercise, the 2020-25 period will be based on a constant balance sheet (which is similar to normal stress tests) but the remainder on a dynamic balance sheet. The outcome of this exercise will be published in April 2021. The ACPR plans to build more accurate guidelines from there.

In the UK, the Bank of England's 2021 biennial exploratory scenario will target the resilience of the business models of the large banks and insurers to physical and transition CC risks. The resilience will be tested against three scenarios, each splitting out the risks and the responses to them: early policy action, late policy action, and no additional policy action. The scenarios refer to the transition to a low-carbon economy while abiding with the Paris Agreement's 2°C temperature-increase limit.

Last month, the Swiss financial regulator FINMA announced its intention to require heightened transparency in disclosing CC and environmental risks, especially by financial institutions. It is less likely these days to find a European authority ignoring CC risks for the financial institutions it supervises.

Investors also helped by banks' improving climate-related disclosure

A growing number of European banks are now disclosing non-financial quantitative and qualitative ESG elements of their activities using the criteria recommended by the Task Force on Climate-related Disclosures (TCFD), which are by now almost universally accepted by financial and non-financial companies and public authorities. The recommended criteria are clustered into four categories: governance, strategy, risk management, and the most demanding area – metrics/targets.

Banks happen to be the most advanced sector in the TCFD disclosure process. This is worth noting as a clear positive, given that banks are not the economic sector that most threatens the world's climate and environment even if they provide financing to brown companies. Banks' previously built regulatory compliance and reporting culture and infrastructure, as well as a post-crisis drive to increased transparency, could partially explain their interest in CC disclosure.

More banks are also using two widely accepted sustainability reporting standards (different from financial accounting standards) in their ESG disclosure. The Sustainability Accounting Standards Board (SASB) benchmarks, published in

[4]https://eba.europa.eu/sites/default/documents/files/document_library/Publications/Consultations/2020/Joint%20Consultation%20Paper%20on%20%20ESG%20disclosures%20standards%20for%20financial%20market%20participants/882742/JC%202020%2016%20-%20Joint%20consultation%20paper%20on%20ESG%20disclosures.pdf

[5]https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/climate-related_risks/ssm.202005_draft_guide_on_climate-related_and_environmental_risks.en.pdf

[6] The world pioneer in incorporating ESG in supervision seems to be the Central Bank of Brazil, which since 2014 requires all financial institutions to include social and environmental risks in their risk management.

2018, are aimed mainly at investors in mandatory filings, as they identify material sustainability factors likely to impact financial performance.

The Global Reporting Initiative (GRI) standards refer to sustainability information for a wider variety of stakeholders besides investors, such as suppliers, customers, communities, etc.

It is desirable that at some point these two standards converge as this could add clarity for market participants using non-financial disclosures. And it is quite conceivable that at some point, not too far in the future, investors and analysts assessing banks will spend as much time on their TCFD disclosure using SASB standards on CC and other ESG areas as they spend now on financial returns-related metrics.

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