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ESG Challenges and opportunities for the European banking sector: more and better

Thank you for the kind invitation to deliver keynote remarks here at the IIF conference. It is my pleasure to be with you today.

We are living in times of tremendous uncertainties. The past weeks have been particularly turbulent. We have seen significant changes at the geopolitical level, severe climate events in Europe, and most recently, an almost movie-like, last-minute, and very narrow agreement at the COP 29 in Baku.

Dubbed the Finance COP, the most recent COP has highlighted once again one of the most pressing issues we face when it comes to battling climate change: financing. This time, the conference was primarily about agreeing how to finance developing countries' protection against the consequences of climate change. Nations have narrowly agreed to triple their financing to developing countries. It is also becoming increasingly clear that investments and actions need to be ramped up substantially everywhere to meet the goals of the Paris Agreement.

With the European banking sector presenting the backbone of European companies' financing, the topic of financing climate change is naturally very close to my heart.

Financing sustainability and facilitating the needed change is a key opportunity for the EU banking sector. At the same time, we need to ensure that financial risks stemming from ESG factors are well-managed.

This is our challenge for the years to come, and I would like to take this opportunity today to shed some light on where we stand at the EBA and in Europe when it comes to moving forward on the regulatory agenda on ESG. I would like to focus my remarks in three areas: policy related work to manage ESG risks, advances on climate related stress-test assessments and methodologies, and disclosure information on exposures of EU banks portfolios in climate sensitive industries.

Policy agenda in general

Our key objective at the EBA is to contribute to developing a sound regulatory and supervisory framework to support the transition towards a more sustainable economy while ensuring that the banking sector remains resilient.

To do that, we are committed to integrating ESG aspects, with a focus on risks, and in a manner that is consistent with our broader objective of contributing to the stability and orderly functioning of the financial system. ESG is one of our priorities, and ESG aspects are increasingly embedded across our products and activities.

The integration of ESG risks in the regulatory framework includes developments on risk management, disclosures, supervisory practices, climate stress testing, and enhancements to the prudential framework, as well as work to avoid greenwashing.

Today, I would like to highlight a few developments where we can already see substantial progress and outcomes.

Guidelines on ESG Risk Management

We are finalising at the EBA Guidelines on the identification, measurement, management, and monitoring of ESG risks by institutions. ESG, particularly environmental risks, may affect all traditional categories of financial risk through transition and physical risk drivers.

Banks need to handle ESG risks appropriately and develop well-informed business strategies. This ensures the safety and soundness of institutions in the short, medium, and long term. The Guidelines will specify requirements for banks in critical areas, such as materiality assessments of ESG risks and risk assessment methodologies at exposure-, sector- and portfolio level.

Banks will need to embed ESG risks in their core risk management processes, including risk appetite, internal controls, and ICAAP.

The Guidelines will also specify how banks should develop specific plans to address risks arising from the transition process.

In addition, we will also specify how banks should monitor ESG risks through a range of indicators, including forward-looking metrics. Banks will need to assess and integrate forward-looking considerations related to ESG risks in their strategies, policies, and risk management processes.

This includes setting targets and developing implementation and engagement strategies to achieve these targets. The Guidelines take a risk-based view and the plans to address ESG risks should be consistent with transition plans prepared or disclosed by institutions voluntarily or under other EU legislation.

Fit-for-55

While working on the policy-related work to build a comprehensive framework for banks and supervisors, the EBA is increasingly engaged in analytical and risk assessment work in the area of ESG.

Climate risk stress testing is a key component of such quantitative work conducted by the EBA.

Just a few weeks ago, we published the results of the one-off "Fit-For-55" climate scenario analysis. This initiative, developed in partnership with the ECB and other European Supervisory Authorities, takes a broad view of the overall financial system rather than focusing solely on individual firms or in a single sector.

We were asked by the European Commission to assess whether financial institutions in the European Union can remain resilient under several scenarios around a particular policy objective: the goal to reduce carbon emissions in the EU by 55% in 2030.

One adverse scenario we analysed involves the interaction between macro-financial adverse conditions and transition risks, which are climate-related. These risks can materialise when changes in regulation or people's preferences force companies to adjust their business models and operations, leading to increased financial system risk.

The results show that transition risks alone are unlikely to threaten financial stability. Under this scenario, companies will need to make substantial investments in sustainable activities to reduce emissions. This shift can lead to lower profits and increased debt, heightening default risks for certain companies.

When combined with macro-financial shocks, potential system-wide losses, including amplification effects, could grow significantly, amounting to 21% of starting point exposure

These shocks would affect institutions differently across sectors. Banks were less impacted than other financial institutions, thanks to the mitigating effect played by their hedging positions and their lower exposures to market valuations relative to investment funds and insurers. In addition, the impact on financial institutions' balance sheets may be also cushioned by factors like enhancements in banks' income sources, which were not part of this assessment.

The findings of the Fit-for-55 exercise won't result in immediate supervisory actions in individual financial institutions but may inform future policy decisions and supervisory strategies. This will enable us to design policies that balance financial stability with climate goals.

Going forward, we are working on Guidelines to strengthen the methodologies that banks and supervisory authorities can use to better assess climate related risks. We are working on draft guidelines on ESG scenario analysis to support banks in testing their resilience to the negative impacts of ESG factors through the use of different climate related scenarios, specially for credit risk stress testing. We would publish a consultation in these Guidelines in the first half of next year.

We will also develop Guidelines to be addressed to NCAs to specify a framework to ensure consistency when NCAs carry out stress tests under their existing mandates. These Guidelines are meant to support NCAs nor to put farther obligations and thus will not create a mandate for new/additional stress tests to be run by NCAs.

Finally, the EBA is working closely with competent authorities to embed climate risk factors in our regular EU-wide Stress Test. This might take some time, given data and methodological challenges, but we are fully committed to making our stress test toolkit as inclusive and comprehensive as possible.

ESG risk monitoring framework: first results

Finally, I would like to dedicate a few minutes to the disclosures performed by EU banks on their existing loan portfolios as part of a framework to monitor ESG risks. This evidence is based on Pillar 3 disclosure data on climate related exposures.

EU banks are required to disclose ESG related pilar 3 information in a semi-annual basis. We have performed an analysis the EBA of the data reported by banks as of June 2024.

From the data, we found that banks have substantial exposure to non-financial corporates in sectors highly contributing to climate change, implying significant transition risk for the EU banking sector. Average shares of corporate exposures in these sectors are above 70%.

Average exposures in areas subject to elevated physical risk are substantially lower, though less comparable due to varying classifications and degrees of granularity with regards to geographical areas used by banks in their disclosures.

Around half of loans collateralised by immovable property are in buckets with the highest energy efficiency. This may imply potentially lower transition risk in this segment through for instance lower future renovation costs or utility bills. However, these results should be read with caution, given the extensive use of proxies and significant data gaps on energy performance information.

Taxonomy-aligned shares of EU banking books remain low, with the overall EU Green Asset Ratio (GAR) at around 2.5%. Certain assets, like SMEs or non-EU corporates, are of course included in the GAR denominator, however not in the numerator as they are not covered by the taxonomy-alignment assessment. This contributes to some extent to the relatively low GAR observed.

Results of the so-called Banking Book Taxonomy Alignment Ratio (BTAR), which also includes in its numerator non-EU corporates and other corporates not covered by the Non Financial Reporting Directive (NFRD), can be expected to be higher. However, this alternative metric will only apply from 2025 onwards, and on a voluntary basis.

There is significant potential for increases in the GAR over time. EU economies are still in the process of transitioning, and banks will transform and align their strategies and lending practices over time. Expected improvements in data availability will allow institutions to better assess their exposures against the Taxonomy criteria. It should be noted that EU banks' green activities extend beyond the GAR, through exposures to climate change mitigating activities defined by standards other than the EU taxonomy.

To date, many of the collected indicators reveal significant variability across banks and countries. This variability is not only related to different risk profiles but may also reflect different levels of maturity in practices observed at banks when managing climate risk and associated data. Some variation may also be explained by data quality issues.

Future work on the ESG risk monitoring framework will include regularly updating the selected indicators, enhancing and developing the tool over time by adding data and indicators (including on environmental risk beyond climate).

We will launch an initiative at the EBA to provide regularly a set of indicators allowing an analysis of the EU banking sector’s exposure to ESG risks. The challenge of course is balancing data comprehensiveness with relevance and focus. Enhancing data quality should be a goal and we will also cooperate with supervisory authorities and with the industry to address data quality issues.

With that, I would like to conclude.

A lot of progress has been made to date in line with the EBA's ESG roadmap we published two years ago, in establishing the regulatory environment for ensuring ESG risks in the EU banking sector can be measured, monitored and actively managed consistently in Europe.

I have discussed efforts to test the resilience of the banking sector facing increased climate risk, as well as some of the building the tools and frameworks for ESG risk management by institutions and by regulators and supervisors.

But it must be said that a lot more still needs to be done. This is work that we need to continue to pursue as a community. Banks, of course, need to continue to enhance their internal systems, and risk management in this area. Supervisors will continue to monitor and assess the progress made and should carefully evaluate any remaining risks not properly accounted for.

Work also lies ahead for us at the EBA. As I highlighted above, this will include enhancing Pillar 3 ESG disclosure requirements, integrating ESG risks in supervisory reporting templates, new Guidelines to banks on the management of ESG risks and on ESG-related scenario analysis. We will need to deliver on the new mandates received as part of the recent update to the banking package in this area and will further analytical work on the prudential treatment of exposures.

Establishing the right regulatory environment and tools for identifying, assessing, and monitoring climate risk in the banking sector is essential to ensuring sufficient financing for the transition. Allowing banks to identify, assess, and manage environmental risks will not only make banks safer and increase stability in the European banking sector but also steer financing towards sectors and projects that are environmentally sustainable and contribute to meeting the Paris goals.

Strong collaboration between EU institutions, the ECB, and regulatory bodies will be essential to building a resilient and future-ready financial system. Banks, insurers, and other intermediaries must be equipped to support the green transition.

Global collaboration will also be essential. We should push the international agenda to ensure that we continue to effectively addressed the challenges that climate change pose to us across the world.

Together, we must work towards mobilising all available resources to tackle one of the major challenges facing our societies today.

Thank you for your attention.