7-9 September 2022

Eurofi event

Sustainability risks: work in progress

We need to enhance the measurement, disclosure, risk management and supervision of ESG risks

The growing importance of Environmental, Social and Governance (ESG) risks for the EU banking sector calls for assertive actions by all stakeholders, including financial institutions and supervisory authorities. In view of the potential for ESG risk factors to affect all traditional categories of financial risks to which institutions are exposed, ranging from credit risk to market risk through concentration and reputational risks, a holistic approach to managing these risks is warranted. We need to enhance the measurement, disclosure, risk management and supervision of these risks. We also need to assess the prudential treatment of such exposures.

Firstly, institutions need to enhance the measurement and disclosure of ESG risks. Starting from 2023 credit institutions will be required to implement clear disclosure of ESG risks on the basis of disclosures standards specified by the EBA[1]. The proposed granular templates and instructions should help institutions measure and report some of these risks and facilitate access to meaningful and comparable information, allowing stakeholders to assess institutions' ESG performance and risk profile. In this regard, while institutions should enhance their data collection and aggregation processes as soon as possible to meet their disclosure (but also risk management) obligations, they should also gradually benefit from more reliable information from their clients and counterparts, thanks to the EU and international efforts to develop an ambitious ESG disclosure framework. In the EU, the Corporate Sustainability Reporting Directive and the EU Taxonomy are expected to improve significantly the data provided by non-financial corporates, which will among other things allow institutions to calculate and report their green asset ratios. At the international level, the work undertaken by the International Sustainability Standards Board to develop a global baseline of sustainability-related disclosures should also contribute to better availability of data provided by banks' non-EU counterparts. In this context, the EU emerging standards can help establish best practices and drive progress at international level on sustainability risks disclosures.

Secondly, institutions need to further embed ESG risks into their business strategies, risk management frameworks and internal governance arrangements. The explicit integration of ESG risks into various EBA Guidelines – on loan origination and monitoring[2], internal governance[3], remuneration policies[4],

[1] See EBA Implementing Technical Standards
[2] See EBA Guidelines
[3] See EBA Guidelines
[4] See EBA Guidelines

and supervisory review[5] – indicates the overarching nature of ESG considerations. More guidance will follow on risk management, potentially covering requirements around institutions' transition plans and stress-testing practices. The recent publications of the Bank of England and ECB climate stress tests results confirm the need for banks and supervisors to continue building their capabilities to identify and manage these forward-looking risks. These exercises constitute key tools to improve banks' climate risk modelling, pushing them to engage with their counterparties to understand better their climate exposures and helping them, and supervisors, sizing the risks. Internally, banks should continue to enhance their climate stress testing capacities. Ultimately, banks are expected to incorporate considerations on ESG risks into their regular business and risk management.

Last but not least, environmental risk drivers should be properly captured into the prudential regime. This should be grounded in a solid risk-based approach, as prudential regulation should remain geared towards ensuring the safety and soundness of institutions. The EBA's discussion paper[6], which explores the relevance of targeted amendments to the existing prudential requirements to capture these risks more accurately, represents the first step in the assessment of the appropriate prudential treatment of exposures subject to environmental risks and impacts. Here again, a holistic regulatory approach is needed as on-going developments under the Pillar 2 framework, macroprudential capital buffers and accounting rules should be taken into account to design the best prudential response to environmental risks.

The management of ESG risks continues to be work in progress. Progress has been made but more is needed. EBA will continue its efforts to provide a robust framework for identifying, disclosing and addressing ESG risks by institutions and supervisors. It will also monitor these risks in the EU banking sector, including through dedicated and regular stress testing exercises.

[5] See EBA Guidelines
[6] See EBA Discussion Paper