



EUROPEAN CENTRAL BANK
BANKING SUPERVISION

ECB supervisory approach on climate-related and environmental risk

FIN-FSA Conference

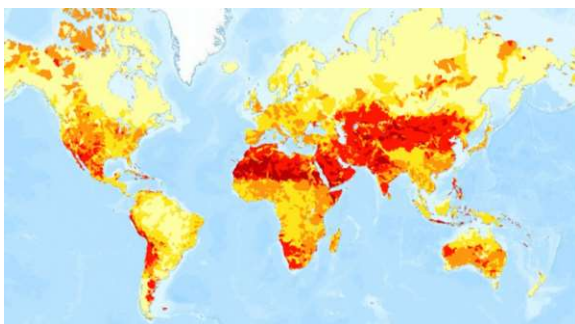
5 June 2024



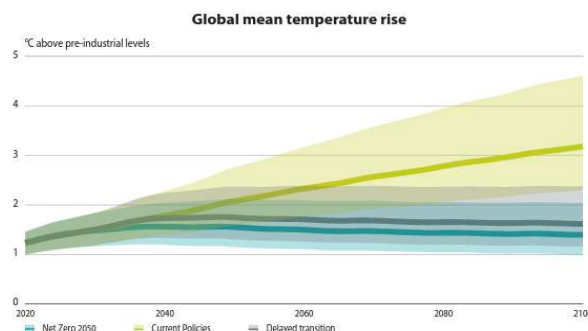
Guan Schellekens, Team Lead,
Climate Risk Project Management Office

Climate-related and environmental risks warrant a bespoke supervisory approach

1. Far-reaching impact



2. Extended time horizon

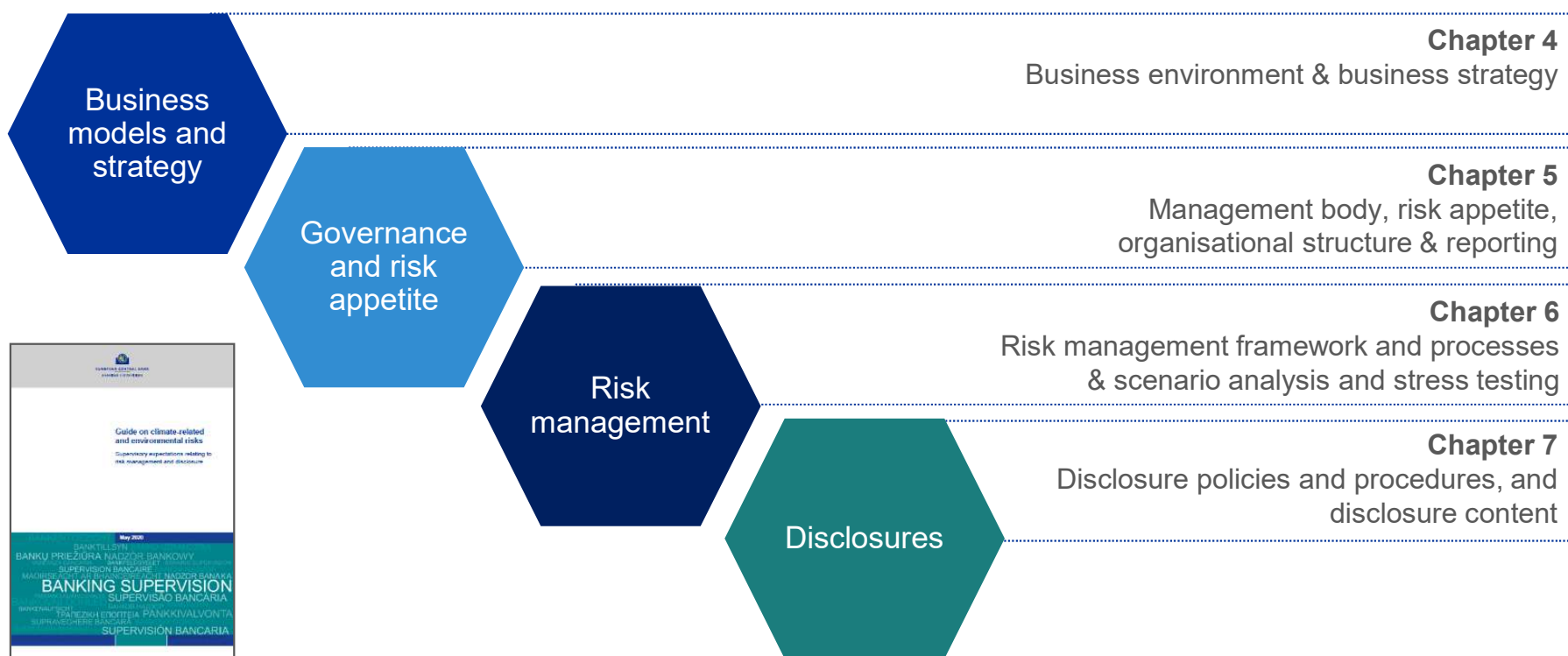


3. Short-term action



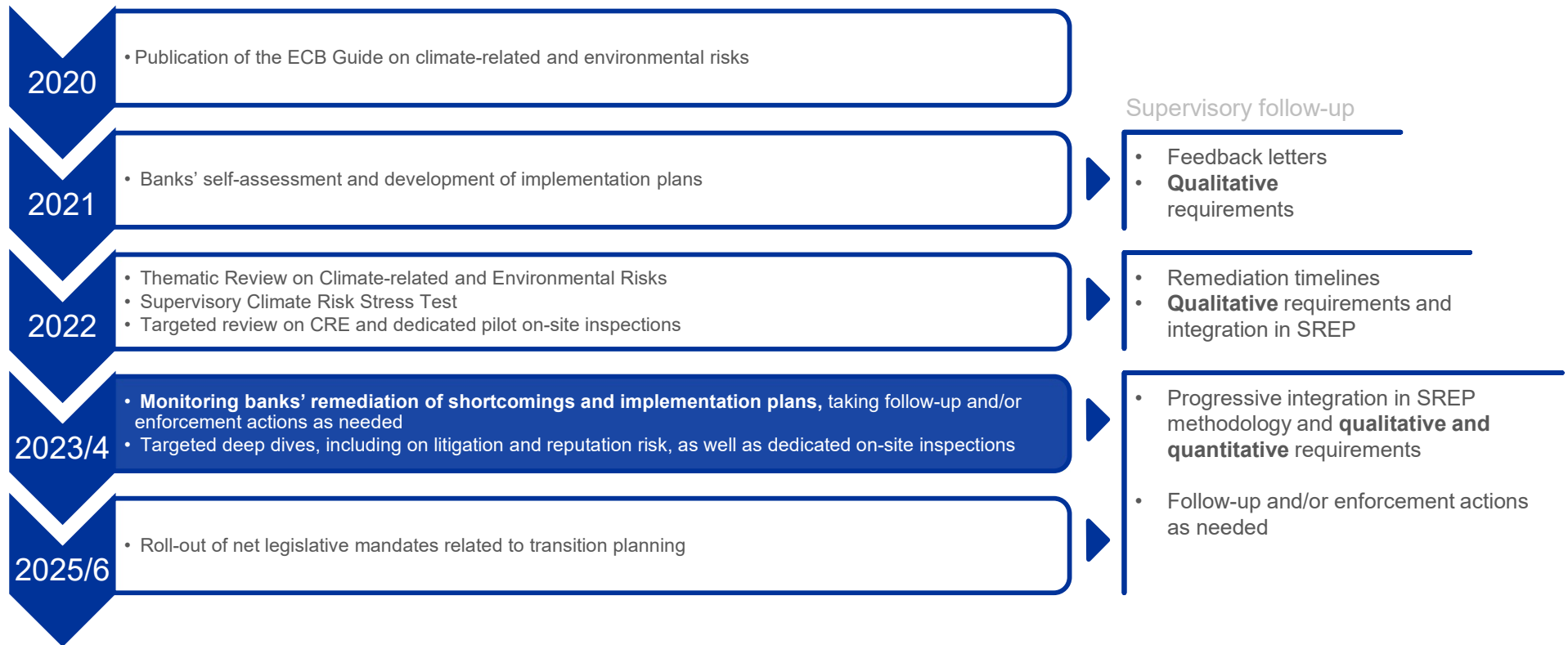
The ECB is of the view that institutions should take a forward-looking, comprehensive and strategic approach to considering climate-related and environmental risks.

In 2020, the ECB published a guide setting out 13 supervisory expectations



Source: ECB Guide on climate-related and environmental risks, November 2020

The ECB conducted various assessments to foster alignment with CER expectations



Thematic review showed that banks are rapidly developing their climate risk management capabilities

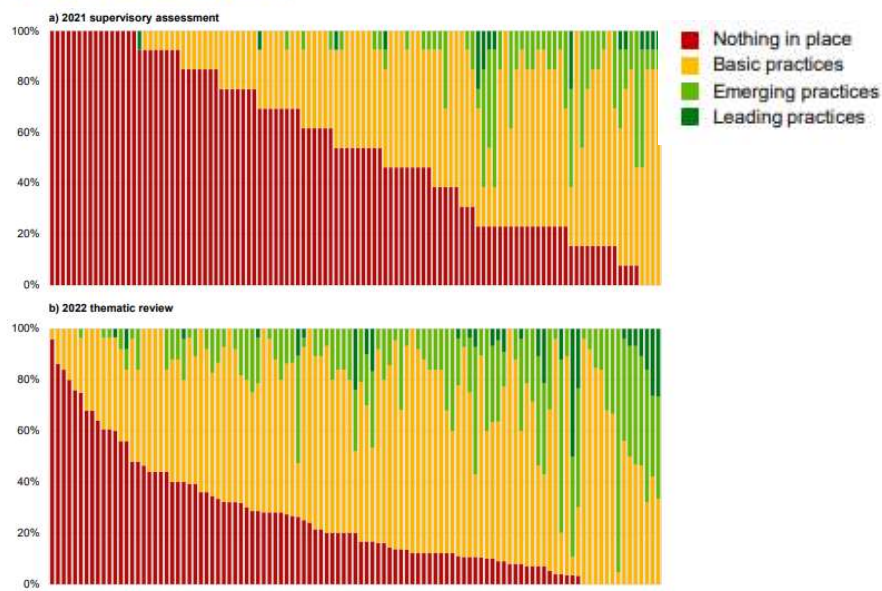
Results of the review (2022)

- Virtually all banks are **out of the starting blocks** to identify and manage their C&E risks
- **Significant increase in 2022 compared 2021**, as in 2021 half of the banks made no or little meaningful progress
- Over **85% of banks now have at least basic practices** in place for at least half of the expectations
- With a **group of banks paving the way**, having emerging practices and leading practices in a considerable number of areas

Chart 6

Bank-by-bank results of the 2021 and 2022 supervisory assessments

The level of maturity of practices across areas of supervisory expectations (bank-by-bank)
(percentages of areas of supervisory expectations)



Source: ECB report, Walking the Talk, November 2022. [Link](#)

Banks broadly acknowledge the materiality of their exposures to the risks

Results of the review

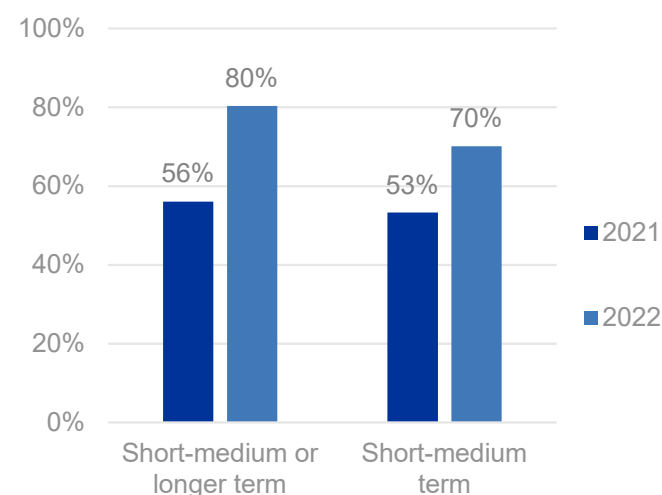
Banks broadly acknowledge **material impact of C&E risks** within their business planning horizon...

- In 2022, more than 80% of banks deem to be materially exposed to the risks, with 70% seeing material risk within next 3 to 5 years
- Banks that deploy a variety of assessment approaches appear to have a better gauge of the risks

... but are likely to **significantly underestimate** their **breadth and magnitude**.

- Blind spots in identification of risks in key sectors, geographies and risk drivers were identified in 96% of institutions
- Moreover, the review showed that 85% of banks do not have a single practice that comprehensively covers all C&E risk drivers that are material or likely to be material.

Percentage of banks that deem to be materially exposed to C&E risks at least for one risk type



Source: ECB report, Walking the Talk, November 2022. [Link](#)

In November 2022, the ECB set deadlines for banks to align their practices with expectations by end 2024



All significant banks received feedback letters with an average of 25 shortcomings.



The ECB has set institution-specific deadlines for achieving full alignment with its expectations by the end of 2024, including the following milestones:

By March 2023

Adequately categorise climate and environmental risks and conduct a full assessment of their impact on bank's activities

By the end of 2023

Include climate and environmental risks in governance, strategy and risk management

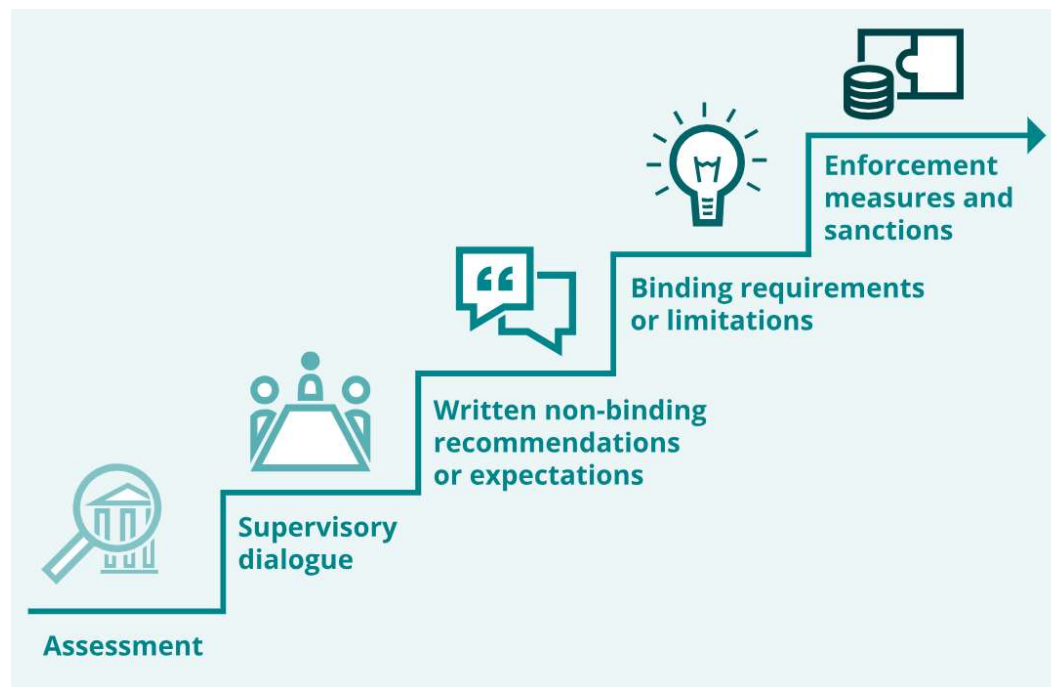
By the end of 2024

Meet all remaining supervisory expectations, including on capital adequacy and stress testing



The ECB follows an escalation ladder, including the potential use of periodic penalty payments

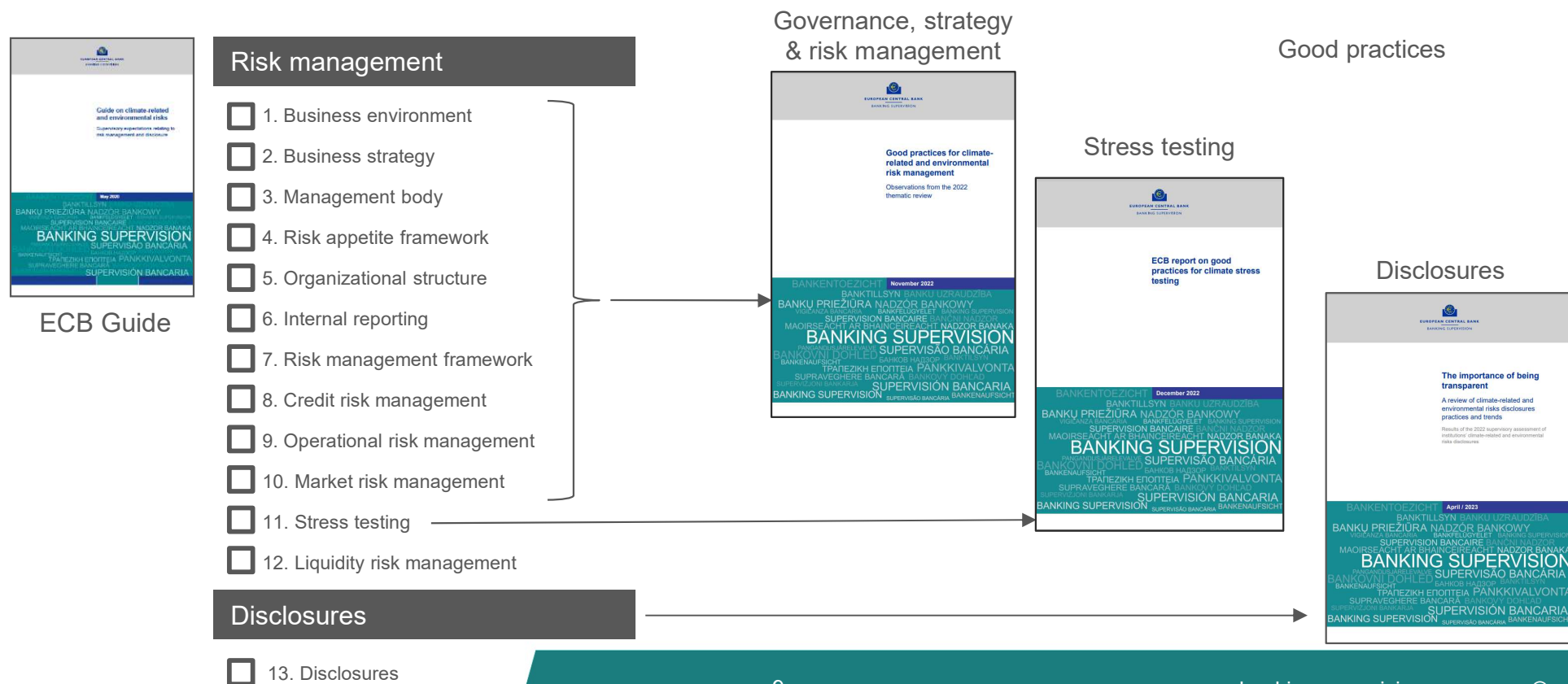
ECB escalation framework



Latest observations

- To facilitate tangible progress where it is most needed, the ECB is determined to make full use of all the supervisory tools and powers available to it under law.
- The ECB has engaged in dialogue with banks since the publication of the ECB Guide in 2020 and provided (non-binding) institution-specific expectations following both initial assessment in 2021 and various further assessment(s) in 2022 (see previous slides).
- While the ECB continues to observe good practices, a number of banks did not remediate its shortcomings. In line with public communication, the ECB issued binding supervisory decisions, including the potential imposition of periodic penalty payments if banks fail on their requirements ('combined decisions')
- The ECB will continue to closely monitor and follow up on the remediation of subsequent deadlines, and in particular those that fell due by year-end 2023.

The ECB continues to observe good practices on CER management, published in various reports

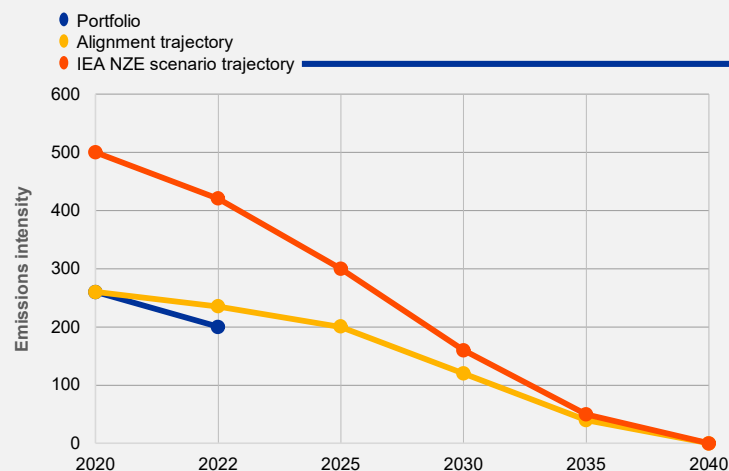


Example of good practice: transition planning

Banks are integrating C&E risks in their strategic target-setting process

- As a starting point, they often exclude new financing of particularly **harmful and potentially risky exposures** such as coal-fired power generation.
- Banks that are more advanced in integrating transition risks into their business strategy also set **short, medium and long-term targets** showing **how their portfolios have to evolve** over time.
- Targets are usually set based on **forward-looking and science-based decarbonisation pathways**.
- Banks **align their Risk Appetite Statement** with the targets.
- Banks show **awareness** of the importance and consequences of **scenario choice** for target-setting.

Stylised example of a KRI tracking the alignment of the emissions intensity of exposures with the institution's transition trajectory



Scenario choice:

- Scenario choice has important consequences. Key aspects:
 - Up-to-date** scenarios
 - Ambition** (e.g. “well below 2° C” vs “1.5° C”)
 - Geographical relevance**
 - Starting point** at base year
 - Internal consistency** of choice

Risks:

- Banks with **net-zero claims not using scenarios that reflect objectives** are exposed to elevated risks (e.g. strategic, transition, reputational / litigation / liability risks)

The ECB is also developing advanced analytics to improve measurement of transition risk

Published in January

Contents

- Demonstration of alignment assessment approach for measuring transition risk, including detailed description of methods
- Analysis of risks of misalignment for the European banking sector based on Anacredit
- Overview of banks' approaches to address risks from misalignment



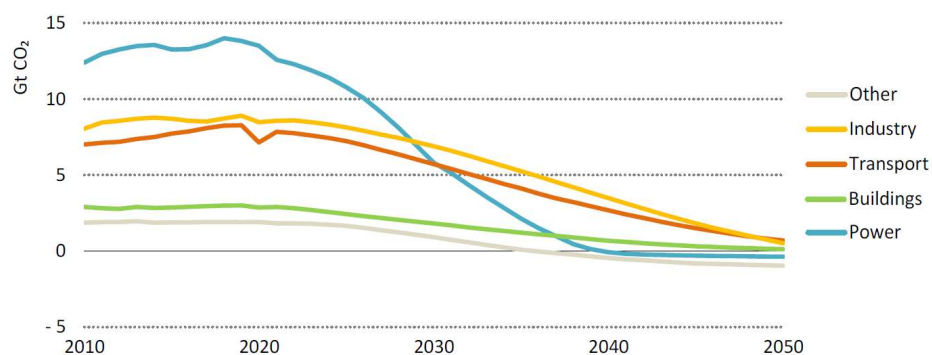
Risks from misalignment
of banks' financing with
the EU climate objectives
Assessment of the alignment of the
European banking sector



- ✓ Assists banks with the **determination of their transition risks**, comprehensively done as per the thematic review
- ✓ Shows how banks can use alignment assessment **to manage transition risk by identifying corporations with elevated transition risks** in key transition sectors.
- ✓ **Provides a concrete option for banks to meet their disclosure requirements** on alignment, due by end 2024 under the EBA ITS
- ✓ **Supports banks to develop their transition planning capabilities**, in view of impending CRDVI requirements

Measuring climate transition risks through assessing alignment with decarbonization pathways

Required emission reductions by sector (IEA NZE*)

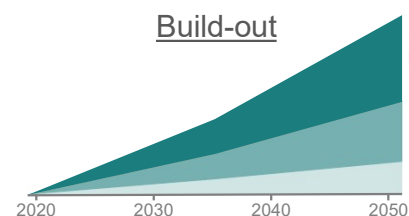


Source: IEA

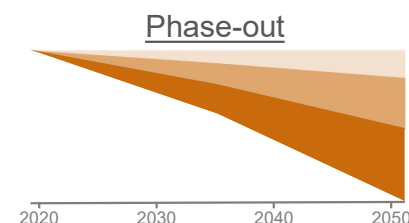
- The transition requires a rapid phase-out of carbon-intensive technologies and a rapid build-out of low-carbon technologies in a number of key transition sectors
- The pace of the transition differs significantly by sector and by geography, in view of the respective position in the supply chain, the viability of low-carbon technologies, level of energy demand and existing production mix
- The bulk of total emission reductions is expected to take place in a limited number of production activities: power, oil&gas, transport, industry (e.g. steel, cement).

Assessment of risk from misalignment

For sectors where the bulk of emissions reductions need to take place, sectoral decarbonisation pathways describe the rate at which specific production assets should change to achieve a given climate goal. To assess transition risks in a forward-looking manner the alignment of (portfolios of) companies can be assessed by comparing their planned production with the decarbonisation pathways.



Technologies like renewable energy and electric vehicles should be build-out over the coming decades.

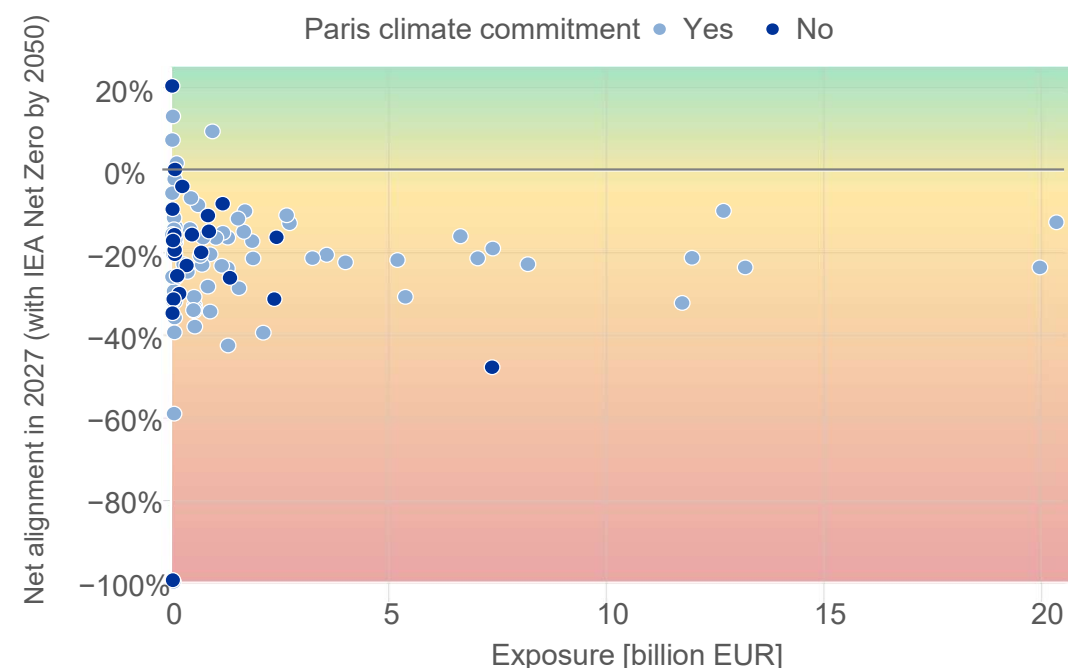


Technologies like coal power plants and combustion engine vehicles should be phased-out over the coming decades.

*The IEA NZE scenario is consistent with EU policy objectives. N.B. The European Climate Law sets out a binding objective for the Union to reach climate neutrality by 2050

The assessment demonstrates that further action is required to reduce risks from misalignment

Deviation of banks' financing from the transition pathway for exposures in 6 key sectors



Notes: Every dot represents a bank. Assessment of alignment compares the rate of change in physical production capacities with a decarbonization pathway. A positive net alignment (>0%) shows that financed production capacities of the respective bank's credit portfolio are transitioning faster than the decarbonization pathway. A negative net alignment from the decarbonization pathway shows the opposite and indicates elevated credit and business model risk.

Source: ECB report, Risks from misalignment of banks' financing with EU climate objectives, January 2024, [Link](#).

- The assessment of alignment demonstrates that **87 out of 95 banks' portfolios are misaligned** in key transition sectors (oil&gas, coal, automotive, power, steel and cement). Banks finance significant productions that will be impacted by transition policy, market dynamics and technology shifts and thus pose **elevated credit risk** that banks need to consider.
- Banks can **further deploy practices to reduce risks from misalignment** by engaging clients and through transition finance, which also serves to **mitigate potential reputation and litigation risks** for banks that have committed to align exposures with the Paris agreement but whose portfolios are still misaligned.

Looking ahead: CER continue to be a supervisory priority for the years to come

Supervisory Priorities 2024-2026

Priority 1: Strengthen resilience to immediate macro-financial and geopolitical shocks

Shortcomings in **credit risk** and **counterparty credit risk management frameworks**



Credit risk

Shortcomings in **asset and liability management frameworks**



Liquidity and funding risk, IRRBB

Priority 2: Accelerate the effective remediation of shortcomings in governance and the management of climate-related and environmental risks

Deficiencies in **management bodies' functioning** and steering capabilities



Governance

Deficiencies in **risk data aggregation and reporting**

Material exposures to **physical and transition risk drivers of climate change**



Climate-related and environmental risks

Priority 3: Further progress in digital transformation and building robust operational resilience frameworks

Main activities as part of the priorities work programme

- > Targeted follow-up on shortcomings identified in the context of the 2022 climate risk stress test and thematic review, with the aim of achieving full alignment with the related supervisory expectations by the end of 2024.
- > Review of banks' compliance with and alignment between implementing technical standards on reporting and Pillar 3 disclosure requirements related to C&E risks, together with a benchmarking of banks' practices against supervisory expectations.
- > Deep dives on banks' capabilities of addressing reputational and litigation risk associated with C&E-related commitments.
- > Targeted OSIs on climate-related aspects, either on a stand-alone basis or within planned reviews of individual risks (e.g. credit, operational and business model).

Looking ahead: the prudential framework surrounding CER will continue to evolve

Obligations for banks under CRR3/CRD6

- **Develop prudential transition plans** (called vulnerability plans), signed off by the management body, to address ESG risks in the medium to long term.
- **Update more frequently the valuation for collateral used for credit risk mitigation** in case of high likelihood to become impacted by ESG factors.

New powers for supervisors under CRR3/CRD6

- Competent authorities to **assess** under their SREP **banks' exposures to ESG risks**.
- Explicit **supervisory powers** for competent authorities to **act on the targets and measures** included in medium and long term prudential (transition) plans.

EBA mandates

- Report on the need to **adjust the prudential framework to account for environmental and social risks**.
- **Guidelines on ESG risk management and prudential transition plans** (in consultation)
- Guidelines on **banks' climate stress testing** (in the next 3 years)
- **Review of the Supervisory Review guidelines** to include ESG risks (by 2026)

Thank you for your attention!