ECB PUBLISHES RESULTS OF THEMATIC REVIEW ON CLIMATE-RELATED AND ENVIRONMENTAL RISKS AND SETS DEADLINES FOR EUROZONE BANKS TO MANAGE THESE RISKS

Last week, the European Central Bank ("ECB") published the results of its 2022 thematic review on climate-related and environmental (C&E) risks. The review, which covered 186 banks (107 "significant institutions" under direct ECB supervision and 79 "less significant institutions" under the supervision of national authorities – *see* list) with total combined assets of €25 trillion, was designed to measure the progress of these financial institutions against the objectives set forth in the ECB's Guide on C&E risks, published in November 2020 (the "Guide"). These objectives are intended to ensure that that the Eurozone banking sector is effectively addressing C&E risks.

The ECB also published a compendium of "good practices" for C&E risk management based on the thematic review. These followed the publication by the ECB in July of the results of its climate risk stress test and the publication in March of a gap analysis on progress towards transparent disclosure of bank C&E risk profiles.

Deadlines

Concurrently with the publication of the results of the thematic review, the ECB announced staggered deadlines for Eurozone banks to meet supervisory expectations set out in the Guide by the end of 2024. Banks are expected:

- by no later than March 2023, to adequately categorise C&E risks and to conduct a full assessment of their impact on the banks' activities, including a robust review of the business environment;
- by no later than the end of 2023, to include C&E risks in their governance, business strategy and risk appetite, as well as in risk management (including in respect of credit, operational, market and liquidity); and
- by no later than the end of 2024, to meet all remaining supervisory expectations on C&E risks outlined in the Guide, including full integration in the Internal Capital Adequacy Assessment Process (ICAAP) and stress testing framework.

In individual cases, the ECB considered institution-specific circumstances warranting deviations from the expectations on full alignment and minimum milestones. Progress by some banks, such as in respect of risk profiles, warranted earlier expected remediation dates. In other cases, slight increases in minimum milestones will be permitted. Failure to meet the deadlines, as noted in the ECB's November 2nd press release, could have capital implications for the errant institutions.

Results of the Thematic Review

The thematic review concluded that:

- More than 80% of the banks have concluded that physical risks and transition risks have a material impact on their risk profiles and strategies, with 70% seeing the material risk within their business planning horizon of three to five years.
- Over 85% of the banks have performed initial mapping of their risk exposures, allocated responsibilities within the organisation, set initial key performance and risk

indicators, and developed a qualitative mitigation strategy for at least part of their risk exposures ("basic practices"). However, the approaches still lack methodological sophistication, the use of granular information on risk and/or active management of the portfolio and risk profile.

- Some banks have embraced scientific pathways to assess their portfolio alignment with the Paris Agreement and set concrete intermediate targets showing how portfolios have to evolve over time to meet longer-term objectives, including reaching net-zero by 2050. These banks are adjusting their product offerings, establishing policies to phase out specific activities within a certain timeframe and engaging with clients, taking client-specific actions to mitigate the risk of misalignment with the institution's objectives. They have processes in place to respond to cases where engagement fails, such as ultimately abandoning client relationships. Transition planning policies, processes and actions are integrated into organisational frameworks.
- However, the bad news is that, at this stage, a wait-and-see approach in strategy-setting is still prevalent in most banks. In particular, long-term strategic commitments are not supported by intermediate targets, limits and thresholds, or these are set such that there is negligible immediate impact on the institution's exposure profile. The ECB notes that banks are exposed to elevated risks, including potential reputational, litigation and liability risks where they do not adequately follow up on their commitments. Moreover, it is still rare for banks to test their strategies against various pathways.
- Fewer than 10% of the banks use sufficiently forward-looking and granular C&E risk information in their governance and risk management practices.
    - To assess the full magnitude of the risks, banks first need to develop their data governance framework and more actively collect granular data at the counterparty, facility or asset level in order to develop measurement approaches at higher resolution.
    - In addition, more forward-looking reporting and higher-resolution key risk indicators ("KRIs") at the portfolio level, with well-calibrated limits and thresholds and clear mitigation actions in escalation procedures, are needed to support decision-making.
    - Banks should also more clearly integrate C&E risks into their rating systems, pricing and collateral valuations, and better assess reputational and liability impacts when financing activities with adverse environmental consequences, estimating economic capital needs for all material risk.
- Also in the bad news category: banks continue to significantly underestimate the breadth and magnitude of C&E risks. Gaps in the identification of C&E risks in key sectors, geographies and risk drivers were identified in 96% of the banks and, of these, 60% were considered to be major gaps. For example, for physical risk, many banks only cover certain risks (*e.g.,* flood risk) for individual portfolios (*e.g.*, mortgages in one country), but fail to reflect the full array of risk drivers. Of the 21 banks that did not report that they were materially exposed, the supervisory assessment showed that not a single one had comprehensively covered their main risk types and main portfolios. Moreover, when assessing the extent to which strategies

and risk management processes address identified material risks, the review showed that not one institution has practices in place that comprehensively cover all C&E risk drivers that are material or are likely to be material.

- Approximately 55% of the banks have devised practices, but failed to implement them effectively. By this, the ECB means that they have developed practices at the policy and procedural level, but nevertheless have declared relevant counterparties to be out of scope, have not reflected available information in credit decisions or simply have not implemented the policies and procedures for significant parts of their portfolios.

  This is, in part, because the majority of banks have neither translated strategic objectives into tangible steering of portfolio allocations nor addressed material risks with concrete and consequential limits, tolerances and thresholds. For example, most banks have formulated C&E-related key performance indicators (KPIs) and KRIs, but these seldom are adopted by business lines and portfolios. A clear framework for corrective action is frequently absent.

Concluding Thoughts on the ECB Efforts

The ECB concluded that observed good practices (across business strategy, governance and risk management) suggest that the banking sector can harness innovation to address the challenges posed by C&E risks. These include, for example:

- setting intermediate and longer-term targets using forward-looking tools to avoid the build-up of excessive transition risk in portfolios, fully integrating these targets in the governance, risk appetite and risk management frameworks and reflecting them in the types of products and services offered to clients;
- developing advanced methods to collect granular data to quantify the risks triggered by climate change, including client and asset-level data on actual GHG emissions, water consumption intensity, energy performance certificates and fossil fuel dependency; and
- allocating economic capital specifically to the management of physical and transition risks and integrating the allocations in their rating system for probability of default.

The ECB found that two-thirds of the Eurozone banks now are targeting broader environmental risks, including biodiversity loss, water stress and pollution. The ECB concluded that these efforts are limited to high-level consideration of physical risk and transition risk drivers in materiality assessments and/or the definition of basic exclusion criteria to avoid adverse environmental, and reputational, consequences. Other banks are pursuing more advanced due diligence approaches, biodiversity impact measurements and target-setting for C&E risks.

The ECB actions on C&E risks are yet one more example of the lead taken by the European Union to combat climate change and steer the EU economy more forcefully in the direction of net zero. These actions should serve as a roadmap for US regulators, which have a distance to go to catch up and, regrettably, operate in a far more fraught political environment. That environment may be about to become more fraught.

Efforts of US Financial Regulators

A scorecard released by Ceres in June noted significant progress by US financial regulators in tackling climate change, but concluded that, "[d]espite the strides that federal financial regulators have made over the past 14 months, they still lag far behind some of their global counterparts and what the latest climate science demands are. This regulatory gap could adversely affect U.S. companies and stifle their competitiveness in the global market. While it is encouraging to witness US regulators acknowledging and acting on the climate threat, they must move faster."

As for those US efforts since the summer:

- In September, the Federal Reserve announced a pilot climate scenario analysis exercise to enhance the ability of supervisors and firms to measure and manage climate-related financial risks. The exercise, expected to launch in early 2023 and finish by the end of 2023, assesses the resilience of financial institutions under different hypothetical climate scenarios by focusing on the impact on specific portfolios and business strategies. The exercise is distinct and separate from bank stress tests, which focus on the adequacy of capital, and instead is intended to lead to an understanding of how climate-related financial risks may arise and differ from historical experience.

- In early October, the Office of the Comptroller of the Currency ("OCC") released its FY 2023 bank supervision operating plan, which calls, among other action items, for the agency to better understand climate-related financial risks. At the largest supervised banks, "examiners will monitor the development of climate-related financial risk frameworks and will engage with bank management to understand the challenges that banks face in this effort, such as data and metrics; governance and oversight; policies, procedures and limits; strategic planning, scenario analysis capabilities and techniques; and incorporation of the frameworks into current bank risk management processes."

  This followed the appointment by the OCC of a Chief Climate Risk Officer, who had previously served as the inaugural Executive Deputy Superintendent of the Climate Division at the NY Department of Financial Services and will lead the agency's "focus on development and implementation of climate risk management frameworks for the federal banking system." Last December, the OCC had issued for consultation its principles for climate-related financial risk management, having recognized that "the effects of climate change and the transition to a low carbon economy [present] emerging risks to banks and the financial system" and that banks are likely to be affected by both physical risks and transition risks. These principles focus on the largest US banks (with over $100 billion in total consolidated assets).

  The OCC now has a dedicated climate page on its website.

  The Federal Deposit Insurance Corporation (FDIC) had issued for public comment a proposed set of similar principles in April.

- Also last month, the Treasury Department announced the formation by the Financial Stability Oversight Council ("FSOC") of a new Climate-related Financial Advisory Risk Committee (foreshadowed in its 2021 Report on Climate-related Financial Risks

– see my previous briefing note, available here). The advisory committee is to help FSOC identify, assess and respond to the risks posed by climate change to the US financial system and will play a significant role in ensuring that state and federal lawmakers hear from leading experts on climate-related financial risks.

Concluding Thoughts Overall

As I have chronicled over the past year, climate change remains an existential threat (*see* most recently my briefing note from October 30, available here). The potential manifold consequences of this threat span the entire spectrum of human activity. Financial institutions and the broader financial markets, indeed the global economies, are by no means immune to these threats. Global financial regulators, engaging with external stakeholders, must continue to act to ensure that financial institutions are fully cognizant of the risks and are effectively able to take action to mitigate the risks to themselves and the markets. The threat is global and, thus, coordinated action across the global economies is imperative.

As Gillian Tett, writing in the Financial Times, noted in September 2019 in her call for government action on climate change, "[h]istory shows that extreme information asymmetries produce market shocks. That's what happened in the subprime mortgage saga [that begot the global financial crisis]. It is hard to believe it will be any different with climate change."

At the very least, policymakers in the individual global economies must not stand in the way of these efforts. At stake ultimately is the resilience and stability of the global economies.

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Mark S. Bergman
7Pillars Global Insights, LLC
Washington, D.C.
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