WSBI World Congress 2022

Paris, 08/07/2022 (date of delivery)

The role of banking in transitioning to a sustainable economy

Introduction

Thank you for inviting me. It's my pleasure to speak here at the 26th Congress of the World Savings and Retail Banks Institute.

As many of you are well aware, sustainable finance has been a top priority in the EU policy agenda over the last several years and will remain as such in the years to come. It plays a key role in delivering on the policy objectives under the European Green Deal as well as the international commitments on climate and sustainability objectives.

Banks play a key role in allocating finances for the functioning of the economy. As a result, they can contribute to channelling private investment towards the transition to a climate-neutral, climate-resilient, resource efficient and fair economy.

The European Banking Authority, together with other policymakers and regulators, is working hard to create the right framework to support banks in their journey. We are actively supporting the process to integrate environmental, social and governance - in short ESG - considerations in the EU banking sector.

Let me start my intervention with an overview of what we, as the EBA, have been trying to achieve through our mandates and initiatives before I move on to why savings and retail banks play an important role in achieving European Union's environmental and social objectives.

ESG in the regulatory agenda

Our ESG regulatory agenda covers a wide range of elements of the regulatory framework, including risk management, disclosures, supervision, stress-testing and prudential elements.

At the start, like any other issue, is all about management. If banks are confronted with a new risk they need to start by making sure that they incorporate into their management structures the right mechanisms to proactively measure, manage, monitor and report on the impact of these risks in their activities.

A year ago (June 2021), the EBA published its report on management and supervision of ESG risks, which provides common definitions of ESG risks, identifies evaluation methods that are needed for effective risk management, and recommends integrating ESG risks into business strategies, governance and risk management as well as in the supervision.

The EBA provides recommendations for institutions to incorporate ESG risks-related considerations in strategies and objectives, governance structures, and to manage these risks as drivers of financial risks in their risk appetite and internal capital allocation process. The EBA also recommends developing methodologies and approaches to test the long-term resilience of institutions against ESG factors and risks including the use of scenario analysis.

But, of course, to be able to develop methodologies to manage this risk, we first need to get the right data and information on how to assess these risks. That is why we have focused our initial regulatory efforts on disclosure requirements. Early this year we developed and published our **Pillar 3 disclosure requirements on ESG risks**.

Transparency and market discipline is a necessary condition for financial market participants to understand the risks associated with banking activities and investment and to channel capital flows to sustainable economic activities.

The EBA's Pillar 3 proposal aims to help investors and other participants in financial markets to obtain information on the ESG risks associated with banks' lending and investment activities.

The EBA is following a sequential approach with initial focus on quantitative disclosures on climate-change related risks. Although quantitative requirements are currently limited to climate change, the scope of Pillar 3 disclosures will expand to other environmental, social and governance objectives in the future, as the wider EU policy framework moves forward.

Banks should understand the environmental and social impact of their activities, such as their financed greenhouse gas (GHG) emissions, and make them publicly available. Information on carbon related exposures, financed GHG emissions and alignment metrics or assets in geographies exposed to climate-change events is combined with information on mitigating actions, including the Green Asset Ratio (GAR), aligned with the EU taxonomy, and the Banking Book Taxonomy Alignment Ratio BTAR, which includes exposures to nonfinancial corporates not subject to NFRD disclosure obligations.

I realize that currently data availability and data quality is a significant challenge. But here is an area where I believe financial institutions can act as catalysts for the necessary transformation of our productive capacity. Financial institutions provide finance to all sectors of the economy. They have access to every entrepreneur, corporate and household in our society. Credit institutions help them pursue their goals and materialize their dreams by supporting them and providing them financing for their projects, their mortgages and life needs. That is the fundamental role of banks in our society.

I believe that credit institutions, by asking their counterparties to provide more and better information in these areas of ESG risks, will also raise awareness, and encourage discussions on these issues in those nonfinancial corporates. Therefore, also enhancing their understanding, their sensitivity to these topics and their active management of these risks in their activities. This will ultimately help to achieve the highly needed overall transition in our economies.

These disclosure requirements for financial institutions, together with other disclosures such as those that will be required by non-financial corporations under CSRD, will certainly increase data availability and quality, which at the moment is a significant challenge.

This brings me to the third area in the EBA's policy agenda on sustainable finance, that is the **management and supervision of ESG risks**. Data is of paramount importance not only for transparency but also for banks' ESG risk management.

As mentioned before, the EBA recommends financial institutions to integrate ESG risks into business strategies, governance and risk management. Therefore, these risks should also be part of regular supervision being performed by supervisory authorities.

On this basis, the EBA will further work towards the integration of ESG considerations in the supervisory review and evaluation process (SREP) and will provide further guidance for banks on the ESG risk management. ESG risks should be proportionately incorporated into the business model analysis, in particular with regards to the analysis of the business environment, the current business model, the exiting strategy, and the assessment of the viability and sustainability of the business model.

The existing assessment under the Supervisory Review and Evaluation Process (SREP) might not sufficiently enable supervisors to understand the longer-term impact of ESG risks. In this context, the EBA sees a need to introduce a new aspect of analysis in the supervisory assessment, pertaining to an evaluation of whether credit institutions sufficiently test the long-term resilience of the business model against the time horizon of the relevant public policies or broader transition trends, applying at least a ten year-horizon. This means that the time horizon for this part of the SREP needs to be extended to 10 years.

Something to think about carefully is how to apply these standards to small institutions that are operating locally and in the retail sector. It would be a mistake to think that ESG risks is a topic at the group level or for large and systemic banks only. It is a reality for smaller and non-systemic banks too. Activities of those banks operating in local communities may well be concentrated in assets that are subject to physical and transition risks of the climate change or to ESG risks in general. It is, therefore, important to ensure that all institutions materially exposed to ESG risks address them appropriately in their risk management frameworks. While doing so, the regulatory rules need to take into account the principle of proportionality; for instance with regard to the complexity of risk management methods and tools.

Pillar 2 process is a key supervisory tool to assess financial risks, including those stemming from ESG factors, and to apply supervisory measures where necessary. Also here the principle of proportionality is important, which should be integrated in the assessment of bank's individual risk profile, business model, size, internal organisation and the nature and complexity of its activities. When carrying out the assessment and deciding on specific measures to be applied, supervisors should take into account materiality of specific risks. Therefore, for those banks that are significantly exposed to ESG risks the assessment of these risks is expected to be more granular and comprehensive.

We recognise that both banks and supervisors face great challenges in assessing ESG risk, especially when it comes to data and methodologies as well as forward-looking elements and extended time horizons to look at. Whilst it is important to keep the ambitions high, it is clear that the integration of ESG aspects in the risk management and supervisory processes should be sequential. We expect that regulatory developments in the area of data, tools and methodologies will allow improvement of practices over time.

One area of particular focus is testing the robustness of the financial sector, and in particular credit institutions, to various situations of stress arising from environmental challenges. Many authorities have already conducted exploratory exercises on climate related risks, primarily aimed at learning and exploring different approaches and potential challenges. The measurement of environmental risks remains a challenge, also because of their forward-looking nature and uncertainty around future events and their impacts.

In this context, in addition to the initiatives that I have just described, we are also working to embed ESG considerations into our risk analysis and stress testing. As you may know, in 2021 the EBA completed its pilot climate exercise and gained valuable experience throughout. Building on this experience, as well as other similar exercises performed by other authorities, the EBA is preparing a more comprehensive climate stress testing in the EU. These tools should contribute to better understanding of climate risk by institutions and supervisors, allowing development of better strategies and mitigating actions. We will start working on guidelines for banks and supervisory authorities on how to enhance ESG risk management practices including to perform ESG stress testing.

The fourth element in EBA's ESG agenda is the prudential regulation. The EBA is currently working on the assessment of whether current **prudential treatment of exposures subject to environmental risk drivers** is adequate.

When this topic comes up, banks like to challenge the regulators with the "capital question". They would like to know if banks will face additional capital requirements to cover environmental risk (or ESG risks in general). To me the answer to this question should be the outcome of the previous work I outlined. Once we have properly identified, measured, managed and accounted for the risks that an institution may be confronted in relation with ESG, we can assess whether the institution also has the proper controls and level of capital to confront them.

It is therefore in this context crucially important to look at the existing allocation of capital to specific exposures to ensure that the framework continues to reflect the risk of each exposure correctly. How much of the ESG related risks are already being directly or indirectly captured by the existing prudential framework and what additional risk remains unaccounted for. It is also important to assess the correlation and concentration of risks that may arise from ESG factors and to assess whether the consolidated level of risk of the institution is also commensurate with its risk controls and capital levels.

We are currently looking into these aspects and the existing evidence. Two months ago, we published a discussion paper on this topic and there is an ongoing public consultation that we hope will provide us with further insights.

The main questions that we are posing relate to the nature of these risks, our ability to measure them, and their inherent correlations. An additional difficulty is the forward-looking nature of environmental risks and how to best incorporate it into the existing prudential framework.

One thing is clear, the transition to a more sustainable economy is a key policy objective and a wide range of policy tools should be used to foster it. But the prudential framework should not be in that toolbox. The prudential framework exists to ensure that banks are adequately capitalized against the risks they are facing. In the end, a strong and resilient banking sector that adequately assess the risks and is able to properly channel the needed funds is crucial to allow financing the transition to sustainable economy. That is also the overall aim of the EBA work in this area.

Why would savings and retail banks play an important role in the transition to sustainable economy?

Now, let me turn to the question of why savings and retail banks are a vital part of the solution, and why they play a key role in achieving Europe's sustainability objectives.

I am sure you will agree with me that, as the title of your conference this year denotes, savings and retail banks are regionally rooted, yet they face global challenges, like the climate change and social inequality, and also need to be responsive to those global challenges.

Your membership also plays a crucial role in the financing of the European economy. You know better than me, the reliance of the European economy on banking intermediation and the role that savings and retail banks play in that intermediation across the EU.

You know your customers, their businesses, their goals, and their capabilities.

Earlier I argued that an important role the financial sector can have in this transition is to be a catalyst for raising awareness and enhancing our information and risk management of these risks across all industries.

Relationship banking is a key tool that the savings and retail banks can use to facilitate such transition. Your proximity to your customers puts your institutions at a strategic position to work together with local communities to make a difference.

On the one hand, through established relations banks will have access to information on how exposed they are to their counterparties' climate risks, and what this means for their portfolio allocation. A better understanding of the local ecosystem will also help them have a better understanding of the interconnexions that such risks may have on their individual exposures to each counterparty and the risks in your overall portfolio.

On the other hand, they can help improve local environmental and social standards contributing to the transition. We observe that the demand for savings and retail products upholding sustainability standards is increasing. Retail customers care about sustainability, and they want to make a positive difference. Banks need to enable their customers to achieve this.

I also argued that the longer-term nature of ESG related risks poses challenges to our existing supervisory framework and the need to introduce in the framework tools to sufficiently test the long-term resilience of the institutions business model against longer time horizons more consistent with broader transition trends.

Shareholders also play a key role to drive this change. Shareholders' backing of sustainability aspects through a strong view on the long-term viability and sustainability of their institutions rather than overly focusing on short-term performance should help in fostering this transition.

Let me finally add a word of caution before I conclude. Today I have focused my remarks on sustainability issues surrounding the financial sector. As I said at the beginning this is the most important challenge confronting our societies and in which credit institutions will have to play its role.

But, of course, it is not the only one affecting the financial sector. Macroeconomic uncertainty remains high. Technological innovations and transformations in the industry are also deeply affecting the financial sector. These challenges require large investments, redefinitions of the business models of every institution, and new ways of engaging with customers, suppliers and all stakeholders. It is also deeply affecting the competitive landscape. All these requires more than ever a strong vision and active management at the top of each institution. I believe that financial institutions have the capabilities to manage these changes and it is your role as senior managers to drive your institutions through these challenging times.

Conclusion

Let me conclude. Sustainability considerations are becoming a key element in the way banks operate. Transition to a sustainable economy is a long-term commitment and offers both challenges and opportunities. There is now a wider perception that there is no trade-off between sustainability and profitability, and banks can become environmentally, socially, and financially sustainable at the same time.

From a regulatory point of view, credit institutions have already started incorporating the EU rules. Work is on the way but we still have a long way to go. The main challenge is that we need to move fast.

The EBA, in coordination with other authorities, is working on a wide range of tools to enhance the regulatory framework for banks to operate. We will continue to work on these tools and monitor EU banks' practices to identify, monitor, and manage ESG risks but also to support banks' activities towards the transition to a climate-neutral, climate-resilient, resource efficient and fair economy.

Thank you for your attention.