EUROFI

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Environmental risks and the role of banking regulation

Thank you for the kind invitation to deliver keynote remarks on environmental risks and the role of banking regulation.

I am very happy to stand before you in Santiago de Compostela for this new edition of the EUROFI financial forum, a fitting place to discuss this important EBA priority. Much like the *Camino de Santiago* (or *Way of St. James*), transitioning to a sustainable European economy indeed is a challenging yet eventually rewarding journey. However, most of us had a relatively easier way to come to Santiago than the traditional way of pilgrims: we did not walk for weeks to get here. Unfortunately, we cannot expect that the transition towards a sustainable economy will be so easily overcome by technology. Technological developments will help but the transition of our economic structure will not be painless.

Considering the Paris agreement and EU net zero objectives[1], banks have a key role to play when it comes to financing the transition and addressing financial risks driven by climate change and environmental degradation. On both aspects, the EBA stands ready to play its part in accordance with its mandates.

Hence, in my time with you today, I would like to start by providing key observations on the current situation of environmental risks management in the banking sector. I will then highlight the merits of climate risk stress testing in view of an upcoming, important one-off exercise to assess the resilience of the financial sector in line with the EU Fit-for-55 package. Finally, I will elaborate on

[1] COM (2023) 317 final : A sustainable finance framework that works on the ground (June 2023)

the challenges of further incorporating environmental risks in the regulatory and prudential framework, also considering the ongoing revision of the CRR/CRD banking package.

1) Let me now address my first point: the current state of environmental risks management.

Sound environmental risk management is needed as only a robust banking sector that can properly assess the risks involved can effectively fund the transition towards a sustainable European economy. Accordingly, banks must keep taking steps in this area. In fact, recent assessments at BCBS or EU level[2] show that some progress is taking place but also the strong need for further advancing current practices.

On the bright side, climate related impacts are now better understood and acknowledged. Governance and internal control frameworks have progressed substantially, while risk management practices are evolving in the right direction. For example, we observe an increasing consideration of climate risk drivers as part of credit risk management. Of course, collecting granular and reliable data remains a challenge. Nevertheless, some banks are proactively addressing it by relying on targeted questionnaires to their clients, engaging with external data providers or intensifying cooperation with peers and supervisors.

However, more needs to be done. Banks must continue to strengthen their organisational, risk management and quantitative capabilities. Examples include ICAAP, scenario analysis, risk metrics and indicators. Furthermore, current practices suggest uneven progress on the incorporation of environmental risk drivers in the management of risk types other than credit risk. Nature related physical risks and biodiversity impact remains limited, despite their increasing salience at international and European level. Finally, banks need to further build capacity and expertise internally to expand their capabilities to fully integrate environmental risks across their organization.

2) With these observations in mind I will now further elaborate on the relevance and challenges of climate risk stress testing and scenario analysis.

Indeed, climate change and environmental degradation require that we approach risk measurement with in a more forward looking manner, with a higher reliance on scenario assessments and less dependency on historical based information. In this regard, exploring the coverage of climate related risk in the EU-wide stress test framework has high priority at the EBA. In practice, past initiatives by both banks and supervisory authorities provide useful and concrete guidance for next steps.

It is clear that critical challenges lie ahead. These include how to overcome the limited data availability as well as methodological limitations. This was clearly reflected in the results of the May 2021 EBA pilot exercise on climate risks, particularly for client-specific information at the activity level. Moreover, there is a need to develop more comprehensive and forward-looking models and scenarios, covering all specific transmission channels, both for transition and physical risks, as well as the potential compounding of risks. This was one of the key findings of the 2022 SSM climate risk stress test[3].

[2] EBA 2021 Report on management and supervision of ESG risks ; ECB Results of the 2022 thematic review on climate-related and environmental risks.

[3] ECB Results of the 2022 Climate risk stress test, published in July 2022

We are currently working on a One-off Fit-for-55 climate risk scenario analysis which is being conducted by the EBA in collaboration with ESMA, EIOPA as well as the ECB and ESRB[4].
As you know, “Fit-for-55" stands for the EU’s target of reducing net greenhouse gas emissions by at least 55% by 2030. The One – off’s primary aim will be to assess the financial sector’s resilience in line with that legislative package, while gaining insights into the capacity of the financial system to support the transition to a lower carbon economy even under conditions of stress. We will investigate how stress propagates through the financial system and how financial institutions’ reactions might magnify it.

The value added of this unprecedented analysis will be its cross-sectoral and system-wide nature, as opposed to standard solvency stress tests which focus on specific sectors only. This will allow to focus on possible near-term implications that may affect the implementation of the package.

We will launch the exercise by the end of 2023, with results to be published by Q1 2025. We do not expect these results to directly feed into the setting of micro-prudential capital requirements. However, they may nurture future considerations on micro and macro prudential policy.
Looking further ahead, I am also convinced that there is a need for regular climate stress tests. These can be expected to strengthen the collective capacity of both banks and supervisors in this field.

3) This brings me to my last point: ensuring an effective regulation.

The incorporation of environmental risks in the regulatory framework is an on-going, challenging yet important, task for standard – setters. At the EBA, we published our new roadmap on sustainable finance in December 2022, covering all three pillars of the banking supervisory framework and outlining key objectives and timeline for delivering on our mandates[5].

Let me firstly briefly address transparency and market discipline (or Pillar 3). In 2023 banks began disclosing quantitative and qualitative information following the requirements in the EBA Pillar 3 package, with a first reference date December 2022. This will surely contribute to the availability of ESG data – the quality of which is expected to progressively increase - for the benefit of all market participants. At the same time, the EBA is closely following and contributing to the work being developed by other relevant organisations to ensure consistency and coherence across frameworks.

Going forward, as I said before, we also expect banks to continue to strengthen their risk management systems to better identify, manage and report ESG risks. The EBA has initiated work to update several EBA Guidelines to include ESG risks. The guidelines include those on loan origination, internal governance, remuneration policies and the supervisory review and evaluation process or SREP. Further, we will issue guidelines on ESG risk management. These guidelines will allow us to set requirements as to how institutions should account for ESG risks. We expect these requirements to include aspects such as risk appetite, internal controls, ICAAP, management of different financial risk types as well as requirements on transition plans, consistently with other provisions of the EU legal framework. In addition, we will review our EBA Guidelines on institutions’ stress testing to incorporate ESG related risk.

[4] On 8th March 2023, the EBA received, in the scope of the Renewed Sustainable Finance Strategy of the European Commission the final mandate of the One-off Fit-for-55 climate risk scenario analysis. This can be found at this link.

[5] EBA Roadmap on sustainable finance, published in December 2022

Finally, when it comes to the prudential treatment of exposures or Pillar 1, our approach will remain grounded on risk-based considerations, aiming at accelerating the integration of environmental and social risks across the Pillar 1 framework, while preserving its integrity and purpose. Our Pillar 1 report set for publication later this month will lay the foundations for further reports to come in line with CRR3 mandates and propose targeted enhancements to the Pillar 1 framework, which – together with initiatives under Pillar 2 and Pillar 3 – will contribute to better incorporating ESG risks across the framework.

4) Let me conclude.

Advancing further risk management practices in the banking sector, leveraging upon climate risk stress testing or scenario analysis, and refining our prudential framework accordingly are three essential, mutually reinforcing milestones on the path to achieve an orderly and sustainable economic transition. I look forward to working together with all stakeholders to meet this important societal challenge.

Thank you very much for your attention.

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