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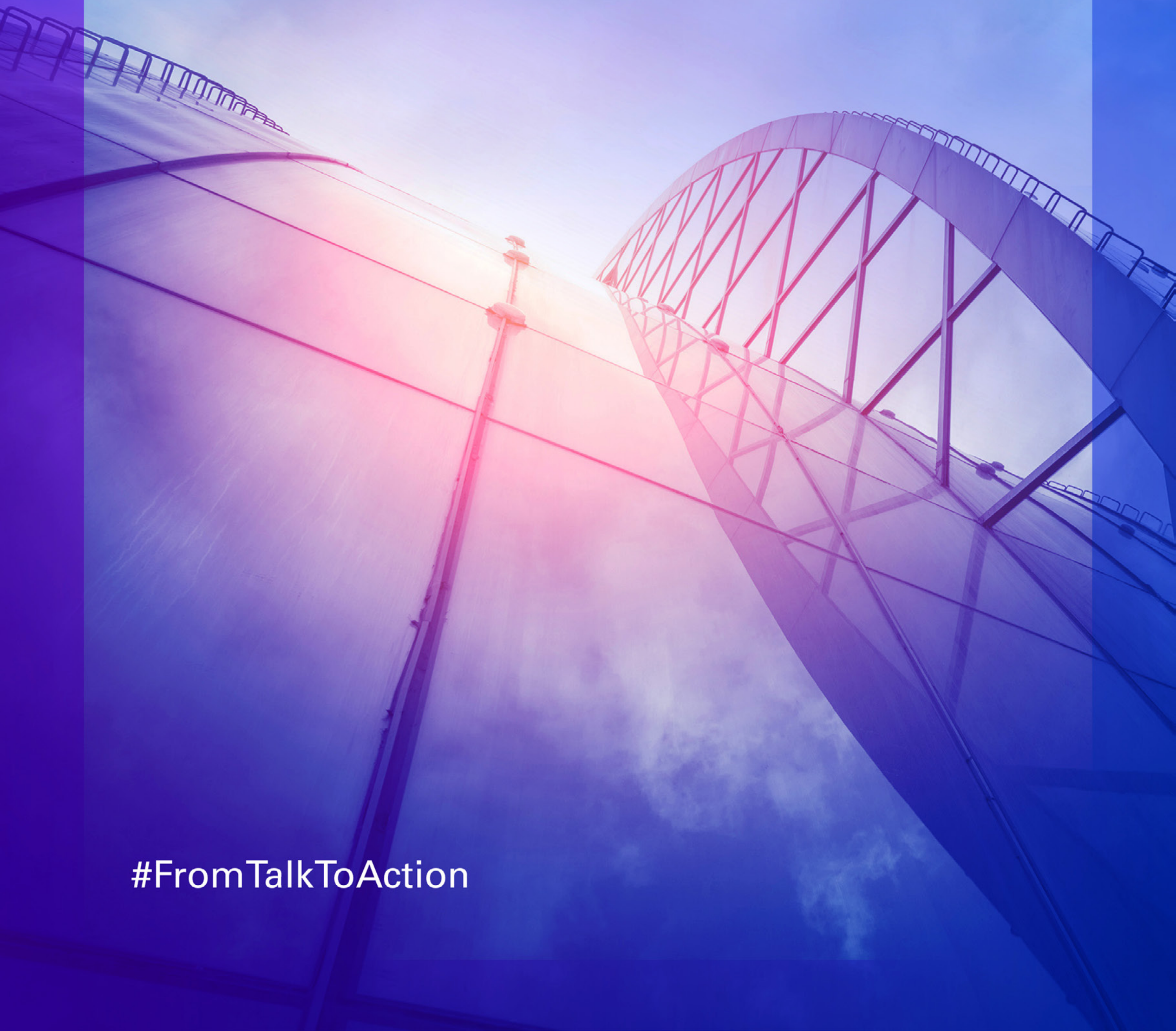
# Insights on Climate & Environmental Risk Management



#FromTalkToAction

The European Central Bank (ECB) has highlighted their concerns on banks' lack of progress on developing their management of Climate and Environmental (CE) Risks. The results of ECB's thematic review highlighted the lack of effectiveness of implementation strategies of European institutions. Consequently, the ECB has set a deadline of the end of 2024 for banks to comply with supervisory expectations on CE risks. Banks must immediately focus on implementing their action plans for climate risk management, ensuring strong cultural embedding within their business model, risk management framework and governance structure.

## Overview:

- In November 2022, the ECB published the results of their thematic review on CE risks.
- The thematic review comprised of a deep dive into Institution's strategies, governance and risk management frameworks relating to CE risks.
- The report was accompanied by summary comments and recommendations on observed good practices to assist banks on how they can move closer to compliance.
- While the review acknowledged that many institutions have made progress on their implementation plans, most banks remain well short of fully reaching supervisory expectations.
- The ECB has now set out a clear directive that institutions must be fully compliant with supervisory expectations by the end of 2024. It has also set out the minimum milestone expectations along the compliance journey.

## Scope:

The thematic review, which concluded in September 2022, was performed on **107 Significant Institutions (SIs) and 79 Less Significant Institutions (LSIs)** across Europe, with a total combined asset level of c. €25 trillion.

The exercise was led by the ECB, supported by 21 National Competent Authorities.

## ECB feedback

Each participating bank was provided with feedback letters from the ECB detailing their **specific shortcomings (on average 25 by bank).**

Specific timelines for full compliance were also set out, with alignment with supervisory expectations required by December 2024.

## Impact on the 2022 SREP cycle:

The ECB has imposed **binding qualitative requirements on more than 30 banks** in its annual SREP to address severe weaknesses identified in the review.

For a small number of banks, the outcome of the 2022 supervisory exercises on CE risks has had a direct impact on their SREP scores.

# Timeline

**The ECB's remediation timelines require institutions to fully align with expectations laid out in guidance by the end of 2024. There will be further supervisory investigations to assess where decisive action is needed.**

Moreover, the ECB expects all credit institutions to reach, as a minimum, the following milestones:

- By the end of March 2023 at the latest, to have in place a sound and comprehensive materiality assessment, including a robust scanning of the business environment;
- By the end of 2023 at the latest, to manage CE risks with an institution-wide approach covering business strategy, governance and risk appetite, as well as risk management, including credit, operational, market and liquidity risk management; and,
- By the end of 2024 at the latest, to be fully aligned with all supervisory expectations, including having in place a sound integration of CE risks in the stress testing framework and ICAAP.

### March 2023

**First phase:**

Categorise CE risks and conduct a full assessment of their impact on the banks' activities

### End of 2023

**Second phase:**

Include CE risks in governance, strategy, risk appetite and risk management

### End of 2024

**Second phase:**

Meet all remaining supervisory expectations on CE risks including full integration in the ICAAP and stress testing

# Key Findings

**We have summarised the key findings published by the ECB below:**

- The European banking sector has shown an increased degree of awareness of CE risk in recent years. This can be attributed, in large part, to ECB guidance and standards. Internal assessments performed by the ECB on the institutions included in the review revealed that more than 80% concluded that CE risks will have a material impact on their risk profile and associated strategies. Complementary to this, **70% of the institutions analysed anticipated a material risk manifesting in the 3–5-year time horizon.**
- 85% of banks have implemented practices assessed as, at least, "Basic" in most areas with regards to CE risk management. The ECB expects banks to further develop forward-looking quantitative approaches and use granular information to reflect CE risks – which has only been achieved by fewer than 10% of banks at this stage. **Banks are required to collect more granular data** at the **counterparty or asset level** to be able to implement more precise quantification methods.
- With regard to transition planning policies and adjustment of product offerings to align portfolios with the Paris Agreement, **a "wait-and-see" approach still prevails for most institutions. The ECB observes some leading practices among institutions** using scientific-based targets, defining concrete objectives over medium and longer-term time horizons.
- In terms of comprehensiveness, blind spots were identified at **96% of banks in the identification of CE risks in key sectors,** geographies, and risk drivers. In 60% of cases, these deficiencies are considered major gaps.
- The ECB also points out a **lack of effectiveness of practices designed by banks, and in 55% of cases,** not implemented for significant parts of the portfolio.
- While huge progress has been made since 2021 on the amount of implemented practices, the **ECB deems only 29% of practices have made substantial progress** since the 2021 reviews. The supervisor has also identified **10% of institutions considered as lagging behind** and not showing any significant progress in implementing the ECB 2021 recommendations.
- Significant Institutions received comprehensive feedback letters, **on average containing 25 observations.** The ECB set institution-specific remediation timelines therein, with a view to maintaining a realistic view of what can be accomplished in institution-specific circumstances, while also ensuring full alignment with all expectations by the end of 2024. Notably, the ECB observed that, **in more than 80% of cases, institutions intend to complete the actions set out in their plans by the end of 2023.**
- **The ECB imposed binding qualitative requirements on more than 30 institutions as part of the Supervisory Review and Evaluation Process (SREP) to address severe weaknesses.** While a handful of institutions had already started setting aside economic capital as part of their Internal Capital Adequacy Assessment Process (ICAAP), for a minority of institutions, supervisory exercises were reflected in SREP scores. These, in turn, have an impact on Pillar 2 capital requirements.

# Summary of key ECB good practices for C&E risks management

**A quarter of institutions demonstrated that they had deployed leading practices in at least one area.** The ECB has encouraged the development of good practices by publishing this selection on the results report. While alignment with these practices does not ensure compliance with supervisory expectations, the content outlines **key considerations for banks to address** in their management of climate risk.

A summary of the key recommendations are highlighted below:

| | |
|---|---|
| **Materiality** | • Establish a **clear definition of materiality for climate risk**, utilising existing processes (such as the Material Risk Assessment used in ICAAP)<br>• Identify the full spectrum of underlying drivers of climate risk and develop understanding of how they affect banks' exposures.<br>• Design a process to determine which drivers have a material impact on the bank's risk profile. |
| **Business strategy** | • Develop a strategy based on state-of-the-art **scientific transition pathways**<br>• **Set intermediate and longer-term targets** using forward-looking tools<br>• Integrate these target-setting processes into the governance and risk management framework<br>• Enhancement of **data governance to include climate risk data fields** – should be aligned with the principles of BCBS 239<br>• Conducting analysis at a sectoral level is critical in determining the impact of climate risk exposure. |
| **Governance** | • Establish **dedicated committees to determine the environmental strategy** and advise the management body<br>• Use advanced methods to **collect client and asset-level data** (GHG emissions, water consumption intensity, EPC, fossil fuel dependency)<br>• Use this data to **develop granular risk indicators**, reported to the management body and included into variable remuneration practices<br>• Development of a **hierarchy of data sources** on a centralised IT platform (e.g. financed emissions, vehicle fuel type, energy certificates)<br>• **Update the Risk Appetite Framework** to include statements on climate risk – with associated metrics, limits and tolerance levels. |
| **Risk management** | • Allocate economic capital specifically to the management of physical and transition risks and integrate this into their rating system for **probability of default.**<br>• Institutions assess capital adequacy **using scenario analysis in their ICAAP**, covering market, credit and operational risks.<br>• **Include C&E risks in IRB models,** for example, by using qualitative variables within scorecards or rating overrides in their PD rating systems |

# How we can help

KPMG are here to support clients to ensure they can meet the ECB's expectation on compliance with CE Risk Guidelines by 2024, through:

- In-depth and sufficiently granularly data collection methods for the purposes of accurately measuring and reporting CE risk indicators.
- Enhancement of scorecards to create heatmaps to incorporate critical data elements relating to climate risks into risk models.
- Development of action plans to implement ECB recommendations in line with industry best practice and supervisory expectations.
- Support the production of roadmaps for future supervisory assessments and integration of CE risk into every aspect of business.
- Assist with the integration of CE risk in the Internal Capital Adequacy Assessment Process (ICAAP) and stress testing models, methodologies and frameworks.
- Provide independent assessment and validation of climate risk models and methodologies

**For further information or if you have any questions on the contents please get in touch.**

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