



EUROPEAN CENTRAL BANK

BANKING SUPERVISION

ECB opinion on the banking package

Focus on transition plans

** Presenter views do not necessarily reflect
those of the ECB.*

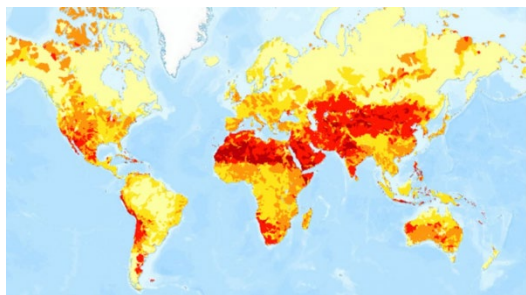
30/05/2022

Carlo Di Maio
Supervisory Policy Division

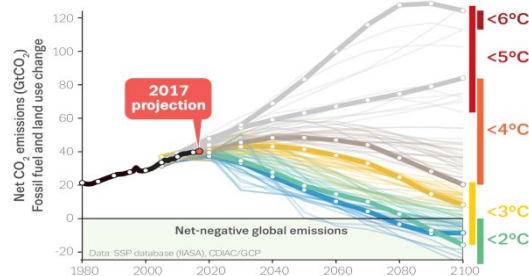


Characteristics of climate-related and environmental risks

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.

ECB opinion on CRR3/CRD6: focus on ESG

Banking package	ECB opinion
<p>ESG risks</p> <ul style="list-style-type: none">• Introduce explicit rules on management and supervision of ESG risks, such as:<ul style="list-style-type: none">a) obligation for financial institutions to assess and manage ESG risks, including binding plans to manage transition risks;b) ad hoc powers for CAs to address ESG risks in the short, medium and long termc) Definitions, reporting/disclosures and changes to scope and deadline of EBA Report on Pillar 1	<ul style="list-style-type: none">• Strong support for general objective• Acknowledge prioritization of work on C&E risks over S&G• Support requirement for plans to manage transition risks and enhanced supervisory powers• Call for developing EU-wide science-based climate risk scenarios• Call for prioritisation of some EBA work-streams and alignment with EBA definitions• Welcome the proposal to proportionally apply the disclosure requirements concerning ESG risks to all institutions, and the new reporting requirements.• Welcome earlier date for P1 report

CRD6 proposal on plans to manage transition risk

Banks (Art. 76)

- The Management Body (MB) is charged with managing ESG risks and reviewing their short, medium and long term impact.
- The MB shall develop plans and target to “monitor and address the risks arising in the short, medium and long-term from the **misalignment of the business model** and strategy of the institutions, **with the relevant Union policy objectives**” with respect to ESG.

EBA (Art. 87a)

- The **EBA is mandated to issue guidelines on the transition plans**. These shall include timelines, targets and milestones.
- Other EBA mandates include minimum standards and reference methodologies, covering also ESG assessment criteria and ESG scenarios

Competent authorities (Art. 87a, 104)

- Competent authorities (CAs) are mandated to **ensure that institutions manage ESG risks and test their long-term resilience** to negative ESG impacts. CAs shall consider a time horizon of at least 10 years.
- CAs are also mandated to **assess and monitor the plans to be prepared by banks, as well as the progress and the risks arising from the adaptation of their business model to the EU policy objectives**.
- Competent authorities are also **empowered to require institutions to reduce the risks arising from the institutions’ misalignment with relevant ESG policy objectives of the Union** relating over the short, medium and long term. CAs may require institutions to adjust their business models, governance strategies and risk management.

EBA report: strategic resilience to ESG risks

- Institutions are, and should remain, responsible for designing their business strategies, including their approach to supporting sustainability policy objectives.
- However, **the extent to which an institution's overall exposures diverge (e.g. are misaligned) from those objectives could serve as an indicator of the scale of its transition risk.**
- On the other hand, **by steering business in a direction that is consistent with the expected environmental and social transformation, institutions are more likely to avoid the negative financial impacts from ESG risks.**



ECB Opinion on the mandatory plans

The Opinion:

- **Supports the inclusion** of ESG risks and related plans to manage transition risk in **prudential regulation**:
 - Bridge the gap between long-term commitments and short-term actions.
 - Increase transparency on the risks arising from the transition.
 - Proactive review of the reputation and litigation risk arising from misaligned business strategies.
- Calls for the CRD6 to **anticipate the EBA deadline for the mandate on transition plans** to 12 months, to ensure timely implementation
- **Welcomes the enhancement of the related supervisory powers** in a manner that is consistent with the time horizon for the materialisation of ESG risks.
- Recalls the importance of integrating **scientific analysis into policymaking**, thereby highlights the need to **define science-based transition pathways**, in order to provide an objective benchmark to assess the risk of misalignment.

Other stakeholders



Climate-related financial risk management and the role of capital requirements

Prudential Regulation Authority
Climate Change Adaptation Report 2021

PRA: manage risks w.r.t. pathways



HONG KONG MONETARY AUTHORITY
香港金融管理局

Supervisory Policy Manual

GS-1

Climate Risk Management

HKMA: consider risk of inaction



Office of the Comptroller of the Currency

Principles for Climate-Related Financial Risk Management for Large Banks

OCC: public statements vs strategies

PACTA / Climate Scenario Analysis Program

PROJECT PACTA FINANCIAL INSTITUTIONS

PACTA: climate scenarios

Task Force on Climate-related Financial Disclosures

Guidance on Metrics, Targets, and Transition Plans

TCFD: disclosure of plans

The Glasgow Financial Alliance for Net Zero

Our progress and plan towards a net-zero global economy

GFANZ: voluntary net-zero targets

Thank you



EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Integration of climate risk into credit risk management

Commercial Real Estate

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30 May 2022

ECB - PUBLIC
FINAL



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1. Introduction

CRE sector has considerable impact on climate risk, while banks provide significant funding to sector



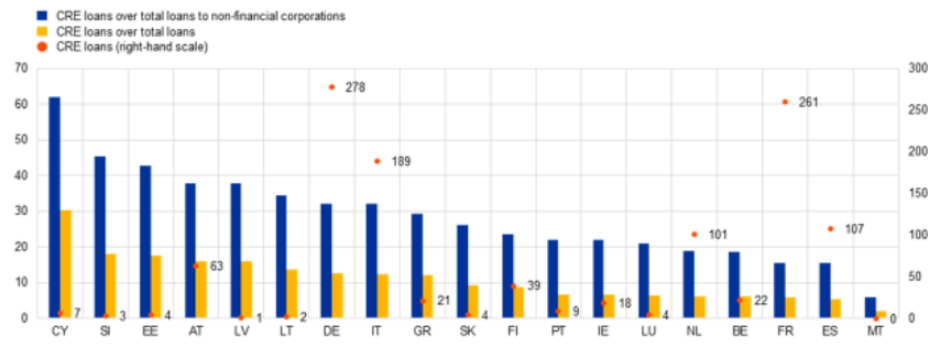
Building sector has one of the highest carbon footprints worldwide - sector accounts for 30% of global greenhouse gas (GHG) and ~40% of the world's energy*



Banks lend significant amounts to the CRE sector – 8% of total loans and advances, while it accounts for over 20% of total corporate loans**

CRE exposures by country

(left-hand scale: percentages; right-hand scale: EUR billions)



Source: FINREP data.

Notes: Data as at the fourth quarter of 2020. CRE exposures as defined in ESRB Recommendation ESRB/2019/3.

*Sustainable Real Estate Investment – United Nations Environment – Finance Initiative

** Data as of 4th quarter of 2020: FINREP data

2. Climate risk impact on credit risk

As bank funding is high to the sector, impact on credit risk could also be significant

Existing buildings:



Older buildings will need to be improved in order to reduce carbon emissions but cost of retrofitting might be prohibitively high and impact on the sustainability of cashflows



It may be easier in some cases to tear down building and start over, rather than retrofit, however borrowers may not have sufficient cashflow to proceed with this option

New properties:



Costs of construction may be higher which might impact on the viability of new projects / limit the supply of new buildings



At a basis level credit risk will increase where:

- **Borrower affordability deteriorates**, as some borrowers will not be able to afford to retrofit poorer quality buildings or the cost of new construction is too high – especially when compared to the cash flow generation capacity of the property (which is suppressed in some CRE sectors such as offices and retail)
- **Collateral valuations decrease** (cost of CAPEX increases) and therefore losses (provisions) increase

2. Climate risk impact on credit risk

Banks are expected to integrate climate risk into credit risk management

Climate risk should be integrated into several risk management aspects*:

Risk appetite
frameworks

– limits to reduce
exposure to climate risk

Credit underwriting &
loan origination
standards

– to incorporate an
assessment of climate risk

Pricing

– to differentiate levels
of climate risk

Risk Modelling

– to quantify the impact of
climate risk

To integrate climate risk into these credit risk management practices, accurate data is required to adequately capture the risk!

*ECB Guide on climate-related and environmental risks,
Expectation 8: "In their credit risk management, institutions are
expected to consider climate-related and environmental risks at all
relevant stages of the credit-granting process and to monitor the
risks in their portfolios

3. Accurate data: basis for good risk management

While data is key to improving risk management, 'real' data availability is still poor

EPC data availability is still poor in banks – ECB requested real data on CRE exposures from a sample of banks and only 37% of EPC data could be provided – including proxies

Yet, some structural challenges make it difficult to collect data from borrowers:

- **Non-obligatory:** For existing stock of loans, legal agreements already in place do not explicitly require data to be provided
- **Unavailability:** In some countries, EPC registers are publicly available making it easier for the banking industry to collect data but in others, registers are still not publicly available
- **Unfeasibility:** It can be complex to calculate EPC ratings on some CRE asset types (e.g. shopping centres)
- **Costly:** The cost for obtaining an EPC rating can be prohibitively high, especially where borrowers are already under financial distress
- **Heterogeneity:** No harmonisation of EPC ratings across the EU which makes it difficult to aggregate data in banks

3. Data availability: basis for good risk management

Despite structural challenges, progress can still be made

- ✓ **For new lending**, existence of an EPC could be a **requirement** for obtaining a loan
- ✓ **For stock**, while challenging, several approaches could be taken to improve the collection of data:
 - ✓ **At annual review**, collect data from existing borrowers on a best efforts basis
 - ✓ Where borrower **requests a modification** to the loan which requires a change to the legal agreement, data requirement could be introduced in order to approve the modification
 - ✓ Every 3 years, an **updated independent valuation** is required, therefore valuers could be instructed to collect EPC data as part of their review
 - ✓ **Incentivise borrowers** to provide EPC data or educate on how to obtain data

Thank you for your attention!

Annex – links to ECB publications

ECB supervisory expectations on climate risk:

https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/climate-related_risks/ssm.202005_draft_guide_on_climate-related_and_environmental_risks.en.pdf

ECB report on climate and environmental disclosures:

https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.ECB_Report_on_climate_and_environmental_disclosures_202203~4ae33f2a70.en.pdf

Newsletter article on real estate risk:

https://www.bankingsupervision.europa.eu/press/publications/newsletter/2022/html/ssm.nl220216_1.en.html