Prudential supervision of ESG-risks

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Prudential supervision of ESG risks

1. ## Mandate of prudential supervisors

   Financial soundness-financial stability, risk based approach

2. ## ESG risks as financial risks

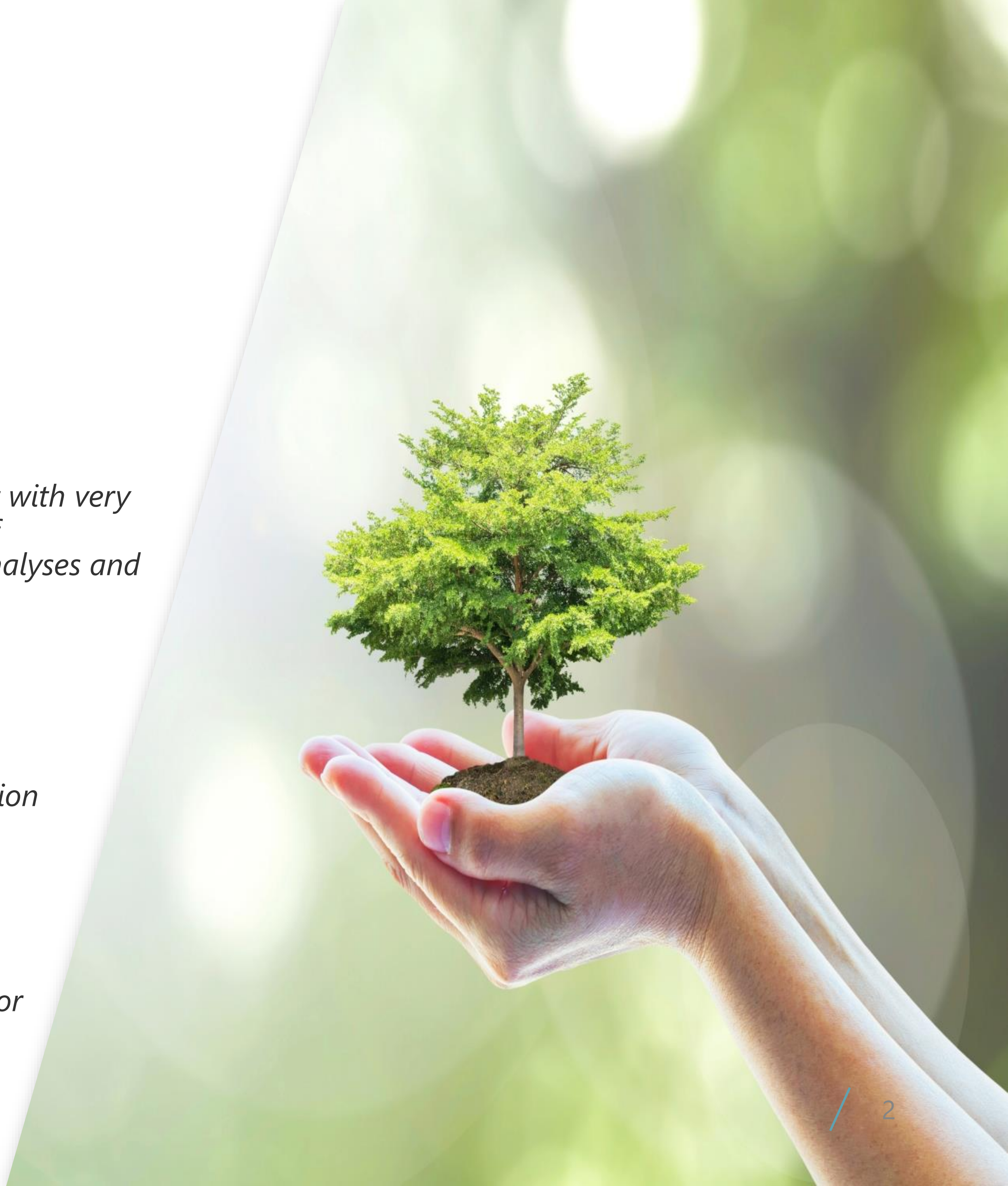
   ESG risks are important risk drivers of traditional financial risks, but with very distinct characteristics, requiring a specific approach. Importance of forward-looking data and methodologies, stress testing/scenario analyses and transition plans

3. ## Prudential supervision of ESG risks

   Microprudential supervision (3 pillars) + macro-prudential supervision

4. ## Focus on prudential ESG plans/transition plans

   There needs to be consistency with CSRD/CSDDD transition plans for those institutions in scope, but prudential plans need to focus on (physical + transition) risks stemming from counterparty exposures



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Mandate of prudential supervisors

- Protect the **safety and soundness of financial institutions +** ensure that the **financial system is resilient to risks**

- **Climate risk and other sustainability risks =** source of structural change in the economy and financial system -> **source of financial risk**

-> within the mandate of central banks and supervisors to ensure the financial system is resilient to these risks

Mandate of prudential supervisors

- **Green investments can also entail risks**

- **Prudential regulation should remain risk-based at all times**

- Goal is **not** to **divest** from certain sectors:

  support companies transitioning + orderly transition

- **Continuing to lend** to non-green companies **without a credible transition plan = NOT sound risk management**

- **Prepare for and adapt to climate related risks** + **client engagement**

- Risk-based approach will **indirectly steer financial institutions towards a more sustainable balance sheet**

- **Real economy policy measures** to actively reorient finance towards sustainable investments

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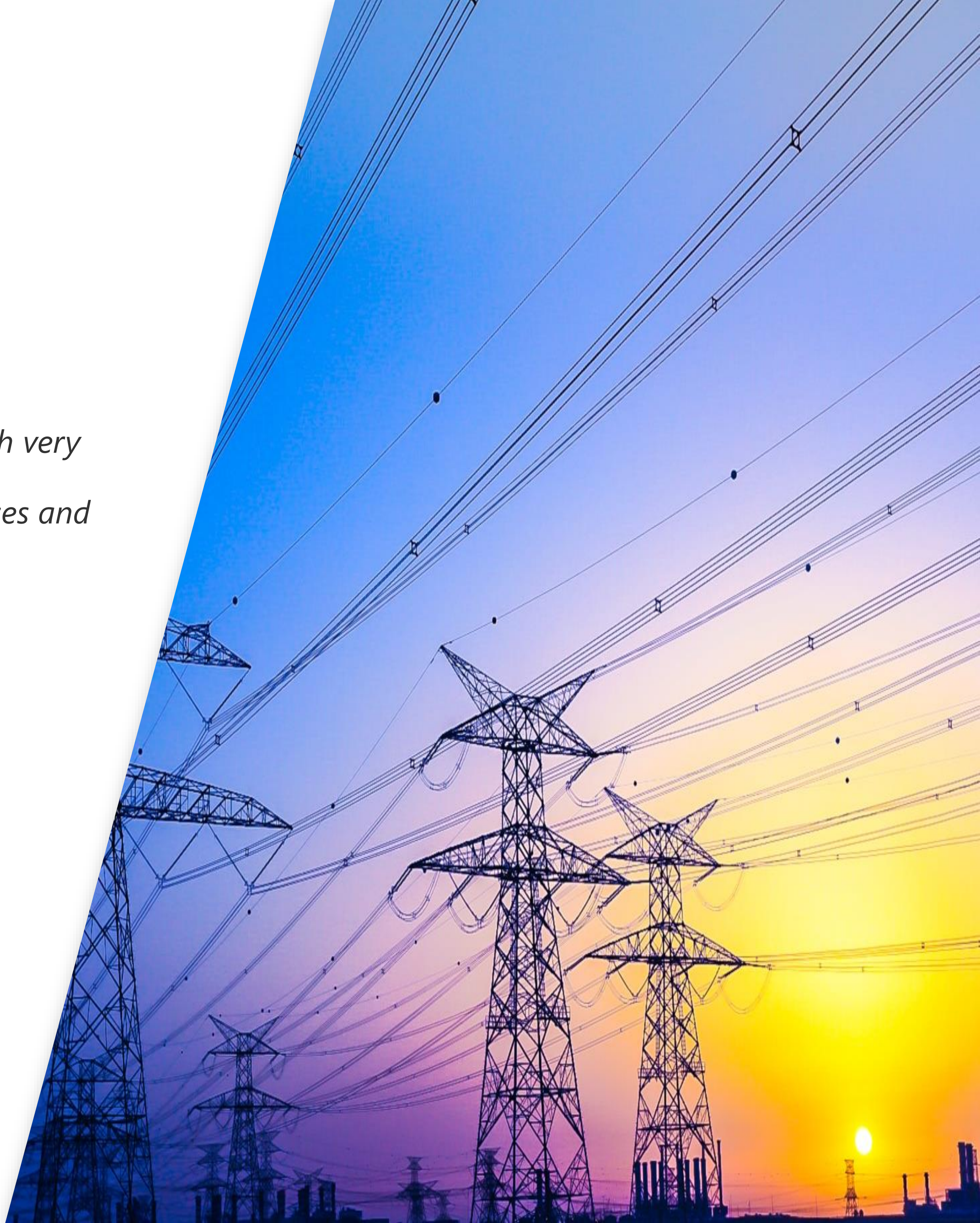

Transmission channels

Importance of looking into various transmission channels, indirect, second order impacts, impacts in entire value chain, feedback loops, contagion risks, compound risks

Financial losses (market losses, credit tightening) feeding back to the economy.

Financial contagion

Physical risk drivers
- Climate change and environmental degradation

Transition risk drivers
- Adjustments to a lower carbon and more sustainable economy

Economy

Corporates

Households

Direct transmission channels

Lower corporate profitability

Lower corporate asset values

Lower property values

Lower household wealth

Increased litigation

Financial System

Credit risk

Market risk

Operational risk (including reputation risk and litigation)

Profitability

Underwriting losses

Indirect transmission channels

Wider economic deterioration (lower demand and output) impacting financial conditions

Assessing climate-related/ESG risks is challenging

Uncertainty	Time horizon	Far-reaching impact in breadth and magnitude	Lack of data

→ NOT focus on what <u>will</u> happen but what <u>might happen</u>, need for forward-looking data and methodologies:

-Scenario analysis/stress tests + transition/ESG risk plans

- disclosures counterparties/client engagement

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Prudential supervision of ESG risks

- **Micro: holistic approach-**working on enhancing data availability, disclosure, reporting, measuring and managing risks and requiring additional capital when needed

Pillar 3	Disclosure			
Pillar 2	Include ESG risks in - business models and strategy - governance and risk appetite - risk management	Stress testing/Scenario analysis+ ESG plans	Supervisory reporting	Inclusion in supervisory review - Discuss with financial institutions plans to step up risk management in line with supervisory expectations - capital add-on/fine if material shortcomings
Pillar 1	Minimum capital requirements	Take C/E risks into account in current framework	Potentially change pillar 1 framework	

- **Macro**

Macroprudential policies to address the financial risks of climate change and nature degradation

Potential Systemic Risk Buffer for climate risk: currently being analysed by EBA/ECB/ESRB

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Requirements transition plans/ prudential ESG plans

	CRD6	CSRD, Corporate Sustainability Reporting Directive	CSDDD, Corporate Sustainability Due Diligence Directive
Context	(Update) EU banking regulation → **prudential framework**	EU sustainable finance → **disclosure**	EU economic regulation → **governance**
Who	All EU banks, proportional	All (~ 40,000) EU companies (including financial institutions) except unlisted SMEs + some non-EU companies (~10,000)	Very large (~ 6,000) EU companies (including financial institutions) + some non-EU companies (~900)
When	11/01/2026	Phase-in from 2025	Phase-in from mid 2027
Plan	**Must adopt & implement**	**Must report, if any**	**Must adopt & implement** **[obligation of means (not of results)]**
	Plan to **monitor and assess the risks** arising from ESG factors, including those arising from the transition process towards relevant Member States & EU objectives ❖ Transition and physical risks ❖ (Probably) no obligation to publish	Plan to ensure that **business model and strategy are compatible** with the limiting of global warming to 1.5 °C and net-zero ❖ Only transition risks ❖ Shall be included in public CSRD report	Plan to ensure, through best efforts, that **business model and strategy are compatible** with the limiting of global warming to 1.5°C and net-zero

Prudential plans for the monitoring and management of ESG risks

- **Minimum indicators + template** will be included in ***EBA guidelines on the management of ESG risks***= to be published beginning 2025: application as of 11/01/26, except for small and non-complex institutions (SNCIs): as of 11/01/27

- **Focus** on the impacts that institutions are exposed to **through their lending counterparties and invested assets**, as these relate to the institution's **core business activities**

- Also requirements with respect to **transition planning process**:institutions should assess and embed forward-looking ESG risks considerations in their strategies, policies and risk management processes through transition planning considering short-, medium- and long-term time horizons

- Take a **risk-based view** and contribute to the overall **resilience** of institutions towards ESG risks

- **Also take opportunities into account**: Next to anticipating potential negative impacts of the transition, banks should take advantage of new opportunities in redefining their business model

- Should be **consistent with transition plans** prepared or disclosed by institutions under other pieces of EU legislation **(CSRD/CSDDD).**

BUT CSDDD:
- has a rather limited scope (only very large companies/ financial institutions)
- Financial institutions: → downstream business partners (= counterparties) are excluded, with a review clause for possible future inclusion
- Limited to climate change mitigatation, alignment with limiting global warming to 1,5°C (transition risks)

consider science-based and up-to-date scenarios originating from national, EU or international organisations

Prudential plans for the monitoring and management of ESG risks

- Consider **several different science-based and up to date scenarios** coming from national, European and internation organisations

- **Double materiality**: To the extent that financial risks of the institution can be impacted by both financial and environmental and social materiality of counterparties they should both be taken into account

Conclusion

Prudential supervision needs to be risk-based, so do prudential ESG plans