Just in Time

Guide on Climate-Related and Environmental Risks

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ESSENTIAL SERVICES FOR FINANCIAL INSTITUTIONS

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01

Introduction

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Context and Scope

- The **European Green Deal** established the objective of making Europe the first **climate-neutral continent** by 2050. To accomplish this, industries are expected to **reduce carbon footprints** and transition into a more **circular economy**. In particular, the financial sector will play a key role in **funding sustainable growth**.

- Transitioning to a low-carbon and more circular economy entails both **risks and opportunities** for financial institutions, while the **physical impact** of climate change has the potential to severely impact the economy and financial system. The ECB has identified climate-related risks as a **key risk driver** on the SSM Risk Map for the euro area banking system, and the ECB is of the view that institutions must take a **comprehensive, forward-looking approach** to climate-related risks.

- **Significant institutions** must consider the extent to which their current management and disclosure practices for climate-related risks are **safe and prudent** within the current prudential framework.

- From the end of 2020, significant institutions will be asked to **inform the ECB of any divergences of their practices** from the supervisory expectations described hereafter, while less significant institutions are encouraged to do the same.
- The guide is **non-binding**, but rather serves as a **basis for supervisory dialogue**.

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Characteristics of Environmental Risk

- **Physical risk** refers to the financial impact of climate change, including more frequent extreme weather, gradual climatic shifts, and environmental degradation.
    - It is **acute** when it stems from extreme events like flooding, drought, storms, earthquakes, etc., and it is **chronic** when it arises from progressive shifts, such as rising temperatures, a rising sea-level, loss of biodiversity, and resource scarcity.
    - Acute physical risks are **less predictable** by nature, while chronic physical risks are foreseeable.

- **Transition risk** refers to the financial impact, either direct or indirect, of **shifting towards** a lower-carbon and more **environmentally sustainable economy**. This can arise from, say, the adoption of new climate-related policies, the emergence of new technological processes, or from changes in market sentiment.

- Physical and transition risk drivers impact economic activity, which then impacts the financial system. These risks can then induce a **domino effect** where financial loss leads to liability risk where an **institutions can no longer repay obligations**.

- Losses generated from climate-related risks depend heavily on future adoptions of climate-related policies and processes. Furthermore, **overall wealth loss is expected** as a result of decreased factor productivity and slowed investment.

- **Climate-related risks are unique** because of their uncertainty, extended time horizon and dependency on short-term action. In the euro-area, although most risks are expected to materialize in the medium to long term, planning must be proactive.

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ECB Expectations

ECB Expectations 1/6

Business Environment & Strategy

- Institutions should **account for all material factors** related to long-term financial interests and solvency when selecting a business strategy.
  - Institutions must **explicitly consider climate-related material factors**, in the short, medium and long-term
  - For example, institutions can measure carbon emission footprint of assets, average energy label of mortgage portfolios, share of assets invested according to a predefined green investment mandate, etc.

- Institutions must understand the impact of climate-related and environmental risks on their **business environment.**
  - The business environment captures **all external factors and trends** that shape an institution's business conditions today or in the future, including climate-related and enrionmental risks.
  - Types of factors to consider include political, economic, social, technological, legal and environmental.
  - Institutions should monitor and document all material factors impacting the business environment as part of regular monitoring of material and emerging risks.

ECB Expectations 2/6

Management & Governance

- The management body should **assign responsibilities** for assessing the different facets of climate-related risk across various functions within the institution according to the **three lines of defense model**
- Additionally, the management body must address the relevance of environmental risks in the institution's risk management framework.
- Management bodies should directly consider the **institution's response** to the objectives of the Paris Agreement (2015) and EU environment-related policies like the EU Green Deal.
- The management body should use **key performance and risk indicators** to oversee all exposures and responses to climate-related risks.
- **Responsibilities** for identifying and assessing climate-related risks should be clearly clearly documented.
- Institutions should describe the tasks and responsibilities of their **first line of defense** with regards to identifying and assessing climate-related risks, particularly those stemming from **credit-worthiness**.

Source: Chartered Institute of Internal Auditors

ECB Expectations 3/6

Risk Management Framework & Disclosures

- Institutions should incorporate climate-related and environmental risks into their existing risk management framework.
  - **Climate-related and enrionmental risk should be quantified** so that it they are understandable within the overall process of ensuring capital adequacy.
  - Institutions should document the impact of climate-related risks on existing risk categories, including both on-balance-sheet and off-balance-sheet risks.
  - Management must decide which risk types are material and **justify any classification** of a risk type as non-material, considering both the short-term and long-term.

- Institutions are expected to **publish meaningful information and key metrics** on climate-related and environmental risks that they deem to be material.

- Institutions must have a well-defined description of climate-related and environmental risks **in their risk appetite statement** with their respective established limits, tolerances and thresholds.
  - Institutions' remuneration policies and practices should **stimulate appropriate environmental behavior**, as should their voluntary commitments.
  - Institutions should specify key considerations that inform their assessment of the materiality of climate-related risks and the frequency and means of disclosures.

ECB Expectations 4/6

Credit & Market Risk

- Institutions should **continuously monitor the impact** of climate-related events on current market risk positions and future investments, and to develop stress-testing scenarios that incorporate climate-related risks.
  - Institutions should be wary of potential shifts in supply and demand for certain financial instruments, products and services.
  - Institutions should be hesitant to invest in companies that are **environmentally unsustainable** or located in **geographically prone regions**.
  - When assessing market risk exposure, institutions should include climate-related risks arising from debt, equity, equity-related instruments, foreign exchange positions and commodities.
- Climate risk should be included in all relevant stages of credit-granting process, with attention paid to **physical location** and **energy efficiency** of real estate.
- Institutions should **avoid loans** collateralized by **energy-inefficient** real-estate or loans to sectors **harmful** to the environment.

Geographical risks include but are not limited to the following:
- Coastal cities are at high risk of flooding in the medium to long-term, but also in the short term from extreme weather events (e.g. hurricane, tropical storm, etc.);
- Regions traversed by rivers are also at risk of flooding over the same time frame;
- Southern European nations are expected to experience more frequent droughts resulting from higher temperatures in the medium to long term.

ECB Expectations 5/6

Operational, Liquidity, Reputational Risk

- Institutions ought to consider the potential for climate-related and environmental events to **affect business continuity**, either directly or indirectly through **depleted liquidity buffers**.

  - Institutions should consider the **location of their operations** and whether they will be able to continue providing service in an environmental disaster.
  - Institutions should consider the impact of climate-related risks on **net cash outflows**, and if necessary, institutions should incorporate climate-related risks into their liquidity buffer calibration.
  - When performing liquidity assessments, institutions should consider both business-as-usual and stressed conditions. In stressed scenarios, they could consider **the possibility of combined idiosyncratic events**.

- Institutions must be aware that their response to climate-related and environmental events can cause sudden shifts in market sentiment.
- **Reputational damage** can result from the immediate practices of the institution, or through partnerships with organizations that are not perceived as engaging in appropriate climate-related practices.

ECB Expectations 6/6

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Stress Tests and Capital Ratios

- Institutions are expected to incorporate climate-related and environmental risks into their **regular stress test analyses**.
- Institutions are expected to assume **unusual but plausible developments** with sufficient severity in terms of **impact on regulatory capital ratios**.
- Stress test assumptions should consider all material risks that may interrupt operations or deplete internal capital
- With respect to climate-related risks, different sets of assumptions should be used, and the following aspects are to be considered at the minimum:
    - How the institution may be affected by physical risk and transition risk;
    - How climate-related risks might evolve under various scenarios depending on technological shifts and climate disaster;
    - How climate-related risks might materialize in the short, medium and long-term depending on the scenario at hand;
    - How the institution will be able to recover in any given scenario.

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Final Remarks

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- The ECB is aware that transitioning to a **climate-oriented focus** is new for many institutions and understands that the general understanding of climate-related risks is **still evolving**.

- Particularly regarding the availability of data and metrics, institutions should do their best to use **quantitative measures** when informing decision-makers in the management body but **may need to settle for qualitative markers** for the time being.

- Institutions are ultimately expected to employ a **holistic approach** when considering the effects of climate change on their business models and processes, always considering various time frames and levels of severity.

- Institutions should **regularly disclose all material information** related to climate-related risks as they arise, and they must justify the omission of immaterial information.

Company Profile

Iason is an international firm that consults
Financial Institutions on Risk Management.
Iason integrates deep industry knowledge
with specialised expertise in Market, Liquidity, Funding,
Credit and Counterparty Risk, in Organisational Set-Up
and in Strategic Planning

This document was prepared in collaboration with Simone Manca and David Silverberg, who at the time were working for Iason Consulting.

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