RegCORE Client Alert

Financial Services: ECB-SSM: Updated report - Guidance on climate and environmental risks

March 2022

Financial Services

ECB-SSM: Updated report - Guidance on climate and environmental risks

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QuickTake

On 14 March 2022, the European Central Bank (**ECB**), acting in its role at the head of the Single Supervisory Mechanism (**SSM**) at the head of the Banking Union, published[1] its updated assessment report (the **2022 Report**) on the progress European banks have made in implementing climate-related and environmental (collectively, **C&E**) risks disclosure expectations. These expectations were first set out in the ECB-SSM's November 2020 Guide on C&E risks (the **November 2020 Guide**).[2]

Consequently, the 2022 Report sets out the results of the ECB-SSM's assessment of Banking Union supervised institutions' (**BUSI**s') compliance with the standards set out in the November 2020 Guide. The 2022 Report also follows on from and supplements the ECB-SSM's November 2021 report on BUSI's C&E risk management.[3] The ECB-SSM concluded in the November 2020 Guide and in the 2021 Report that virtually none of the SSM supervised institutions in the scope of the assessment would meet the minimum level of disclosures set out in the ECB-SSM's Guide and as such the regulator was keen to monitor their progress and report on it.[4]

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[1] Supervisory assessment of institutions' disclosure of climate and environmental risks to be published in March 2022 as an updated report of the previous guide published in 2020, available here.
[2] Guidance on climate and environmental risks, published in November 2020, available here.
[3] Available here.
[4] Specifically, while no BUSI was close to fully aligning its practices with the supervisory expectations, the ECB-SSM recognised that the challenges linked to integrating C&E risks into strategies, governance and risk management arrangements are constantly evolving. Therefore, the ECB-SSM indicated it was committed to continuing dialogue with BUSIs so that they continue to strengthen their management of C&E risks. Other conclusions drawn by the ECB-SSM included:

The ECB-SSM plans to conduct a full review of BUSIs preparedness to manage C&E risks during the first half of 2022 and also plans to integrate C&E risks into its methodology in how it conducts the supervisory review and evaluation process (**SREP**) as well as on-site investigations. The ECB-SSM has confirmed that it will assess BUSIs' C&E disclosures again at the end of 2022. As explored in this Client Alert, BUSIs will need to step up their efforts on compliance with C&E risk management disclosure but also notably in meeting standards more broadly in EU sustainable finance regulation and the ECB-SSM will hold BUSIs closely to account.

Key takeaways from the ECB-SSM's 2022 Report

In total, the ECB-SSM assessed 109 banks that were classified as significant institutions as of 1 August 2021. It focused mainly on the disclosures that were made by Banking Union supervised institutions (BUSIs), as made at the highest level of consolidation under SSM supervision. For large banks with a parent group outside the countries participating in the EU's Banking Union, some information at the international consolidation level was also taken into account, at least where appropriate.

The 2020 stocktake stated that it "…demonstrated that virtually none of the institutions in the scope of the assessment would meet the minimum level of disclosures set out in the "ECB Guide on climate-related and environmental risks." While this may be a low bar from which to start from a baseline measurement, the Report confirmed that BUSIs have shown clear progress, notably in the disclosure of qualitative information, 45% of the banks' disclosures were assessed as insufficient both in terms of content and justification. The ECB-SSM also found deficiencies in how BUSIs disclose their key metrics and provide substantiation for their disclosures.

The 2022 Report's executive summary commented that:

> "…most institutions still need to make significant efforts to transparently disclose their exposures to climate-related and environmental risks and further improve their disclosure practices. The ECB has therefore sent individual feedback letters to the banks under its supervision setting out key gaps in their disclosures and expects them to take decisive action to ensure they convey their risk profile comprehensively. Addressing such gaps will also accelerate institutions' preparedness for meeting impending technical requirements."

Based on this finding, the ECB supervisors will continue to seek to address risk disclosure. Frank Elderson, member of the ECB Executive Board and Vice-Chair of the ECB Supervisory Board, commented on this (see details below) and emphasised that BUSIs must try to compensate the deliberately poor quality of their disclosures by releasing information on green topics, which is not expedient as it does not give regulators any real substance to what both markets and regulators want to know, namely how exposed a BUSI is to C&E risks and what it is doing to manage these.

The Report's conclusions concerning the supervisory review on transparency and materiality of risks and methodologies, on the other hand revealed that one third of the institutions do not yet transparently disclose that they are exposed to material climate-related and environmental risks in line with their internal materiality assessments. Overall, it can be seen that the institutions hardly justify their climate and environment-related key figures and targets, with only one in five institutions disclosing this. An example of such a key figure would be the commitment to align with the Paris Agreement, whose goal is to limit the global temperature increase to well below 1.5°C within the current century. Crucially, more than a third of the institutes, do not disclose these aspects at all. The content of the disclosures leaves something to be desired as well as this is often very sparse and inconsistent.

The current report demonstrates that banks' current disclosures are not sufficient to meet future regulatory disclosure requirements set out by the Corporate Sustainability Reporting Directive (**CSRD**) and the

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- Virtually all BUSIs that performed a thorough materiality assessment expect C&E risks to materially impact their risk profile in the next three to five years.
- Although BUSIs have taken steps to adapt policies and procedures, few have implemented C&E risk practices with a discernible impact on their strategy and risk profile. Management bodies are increasingly taking formal responsibility for the management of C&E risks, however, in most cases, banks have not developed the relevant risk reports to enable their management bodies to exercise this responsibility comprehensively.
- Most BUSIs have a blind spot for physical risks and other environmental risk drivers, such as biodiversity loss and pollution.

Moreover, the November 2021 Report was preceded by a speech by an ECB Supervisory Board Member, much in the same way that the 2022 Report is accompanied by a speech. In the 2021 speech (available here), BUSIs were reminded with concrete examples on the need to incorporate C&E risks into risk governance frameworks.

Taxonomy. The CSRD is designed to ensure that companies report the relevant, comparable and reliable sustainability Information needed by investors and other stakeholders[5] . The Taxonomy establishes a common classification system at an environmentally sustainable economic activities at the EU Level[6] . For instance, while 74% of banks in the sample declared that they disclose Scope 1, 2 and 3 greenhouse gas (**GHG**) emissions, only 15% disclose (some of their) financed emissions. Moreover, only 12% of the banks disclose metrics on their portfolio alignment.

While the ECB encourages BUSIs to disclose the results of such research, the selection of portfolios and the associated reference scenarios do not always ensure a representative overview of the risks to which the institution is exposed. For example, a quarter of the banks in the sample make qualitative reference to the EU taxonomy, while only 7% provide quantitative information in connection with it.

The ECB-SSM's next steps and identified best practices

Upon receiving the results, the ECB-SSM sent individual feedback letters to the respective BUSIs summarising the results of the assessments and explaining the main deficiencies. The ECB-SSM expects BUSI to take decisive action to address the risks posed by climate change and environmental degradation and to fill the gaps in their disclosures. The ECB-SSM announced its plans to review the BUSIs' C&E disclosures again at the end of 2022.

In parallel, the ECB-SSM has also identified three best practices, followed by some of BUSIs, which relate to the following:

Substantiation of disclosures

As part of its climate strategy, which is publicly available, one BUSI had stated that it aims to manage its portfolio in such a way that it is net emission-free by 2050 or earlier. For this purpose, several (interim) targets and the progress made are disclosed and for each of these targets, the institution also discloses the sectors covered, the underlying methodology and the scenarios used to establish benchmarks.

Content of disclosures - risk management

One BUSI, as an example of best practice, disclosed its process for managing and continuously monitoring the environmental and social risks associated with the financing of corporate client activities and facilities. It showed that a loan application may be approved from the perspective of ESG risks if the risks are acceptable and/or the beneficiary agrees to the additional risk control measures and the implementation of risk mitigation measures. Monitoring of loans for ESG risks is part of the regular credit review and credit facilities may be terminated if the ESG risk conditions agreed as part of the additional risk control measures are not met.

This is important, as taking a step back, the European Commission (**EC**) also emphasises that the reporting of climate-related information is of great importance, especially for investors, as it demonstrates how the respective institution identifies climate-related risks, which risks are in the foreground and how these are managed. As such, it is not only important how the processes are described, but also how they are integrated into the company's risk management. The ECB-SSM's analysis shows that in fact only 17% of the significant and thus ECB-SSM directly supervised BUSIs have done this extensively.

In addition, institutions are expected to consider climate and environmental risks in their own credit risk management at all relevant stages of the lending process and to monitor them in their portfolios, as climate-related environmental risks are included in lending policies and procedures.

Disclosure of portfolio alignment methodologies, metrics and targets

One BUSI as an evidence of what the ECB-SSM highlighted as best practice had set a net zero target by 2050 and is actively seeking to align its portfolios with a science-based transition pathway, including technology pathways derived from the International Energy Agency's Net Zero 2050 scenario[7],. Against the science-based transition path, the BUSI has published dashboards showing its loan book performance in various transition sectors, including power generation, oil and gas, automotive, steel, cement and real estate. It also disclosed the indicators used, the underlying methodology and the reference scenarios for each indicator. For each indicator, it disclosed its current and projected performance and set corresponding targets.

[5] More Information about the CSRD available here.
[6] More Information about the Taxonomy available here.
[7] More Information About the IAE's Net Zero 2050 Scenario available here.

Frank Elderson's comments on the 2022 Report

As mentioned above, Frank Elderson, Member of the Executive Board of the ECB and Vice-Chair of the ECB's Supervisory Board, commented on the results of the ECB assessment and emphasised[8] in particular the following:

- The ECB is gradually integrating C&E risk into its regular supervisory methodology, and the way BUSIs manage these risks will ultimately affect their Pillar 2 regulatory capital requirements as part of the SREP process.
- The 2022 Report has shown that the quality of BUSIs' disclosures has improved since November 2020, particularly in the areas of risk management, governance and business models. However, this improvement has been only marginal: in 2021, seven out of ten banks disclosed information on risk management and governance related to C&E - compared to five out of ten in 2020 - while only four out of ten shared relevant information on the inclusion of C&E risks in their strategic considerations - compared to three out of ten in 2020.
- The speed at which regulation and metrics are evolving in this area should leave no doubt that addressing climate and environmental risks and disclosing high quality information is not optional. Banks can and must significantly improve the quality of their disclosures, and they must do so quickly.
- Internationally, there is a growing awareness of the great value of transparent disclosures. Clients, investors and other market participants are keen to receive more and more meaningful and substantiated information about the climate-related actions of their banks (but also other types of BUSIs), as this allows them to track where their money is going. Thus, the consequences of non-compliance with minimum transparency standards for banks will only increase, as the legal and reputational risks for banks that do not improve the quality of their disclosures become greater.
- In its most clear confirmation as of yet, failure to disclose risks, including C&E risks, has been clarified by Elderson as constituting a breach of the EU's Capital Requirements Regulation (**CRR**). Therefore, the ECB-SSM is ready to use all the supervisory tools at its disposal to ensure that banks' C&E risk disclosures meet its standards and that authorised BUSIs are well prepared for the new regulatory requirements.
- In addition, the ECB-SSM aims to prepare an annual report that will publicly list those institutions that have repeatedly failed to disclose their C&E risks, which continues the tradition of "naming and shaming" as used by some national regulators (including those now outside of the EU-27)[9] and recently picked up by the ECB-SSM. It remains to be seen how and on what grounds this may be done as this falls somewhat outside of the traditional supervisory tools and remit of the SSM's powers save for certain tools and publication priorities it may conduct as part of a "comprehensive assessment" exercise.

Outlook and next steps

The ECB-SSM has already sent individual feedback letters to the respective BUSIs explaining their main shortcomings and clearly showing them it expects them to take action to address the risks arising from climate change. These dovetail the individual SREP results and decisions as sent to BUSIs in February 2022. Now the move and pressure for BUSIs will be to improve efforts where they can ahead of the ECB-SSM's further review, which is rather ambitiously scheduled for the end of 2022.

In the first half of 2022 as well, the ECB-SSM is also is planning to conduct a comprehensive review of banks' preparedness to manage climate and environmental risks, including an in-depth review of the integration of climate and environmental risks into their strategy, governance and risk management. This will take place in parallel with the implementation of a bottom-up climate risk stress test and the development of best practices for climate stress testing. Even though we are already halfway through the first half of 2022 no information has been published yet on this and this alert would be continuously updated once more information becomes available.

While the phased incorporation of C&E risks into the SREP processes and review cycle is perhaps welcome, it will have an impact on BUSIs individual Pillar 2 capital requirements as well as lead to more intrusive use of on-site inspections. Consequently, if the publicly available list of BUSIs who have failed to meet their C&E requirements is not enough of an incentive, the perspective of doing poorly at an on-site inspection should definitely work to encourage institutions to take steps in improving to meet the ECB-SSM's supervisory expectations on C&E Risk but also complying with the EU's rules on ESG more generally. Whether this will

8 Comments by Frank Elderson, Member of the Executive Board of the ECB and Vice-Chair of the Supervisory Board of the ECB, regarding the findings of the ECB report, available here.
9 As the FCA's "Dear CEO" letters.

truly be the case remains to be seen. What is certain however is that the ECB-SSM is taking this very seriously and does not intend to let anyone lag behind.

About us

PwC Legal is assisting a number of financial services firms and market participants in forward planning for changes stemming from these proposals.

If you would like to discuss any of the developments mentioned above, or how they may affect your business more generally, please contact any of our key contacts or PwC Legal's RegCORE Team via de_regcore@pwc.com or our website.

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