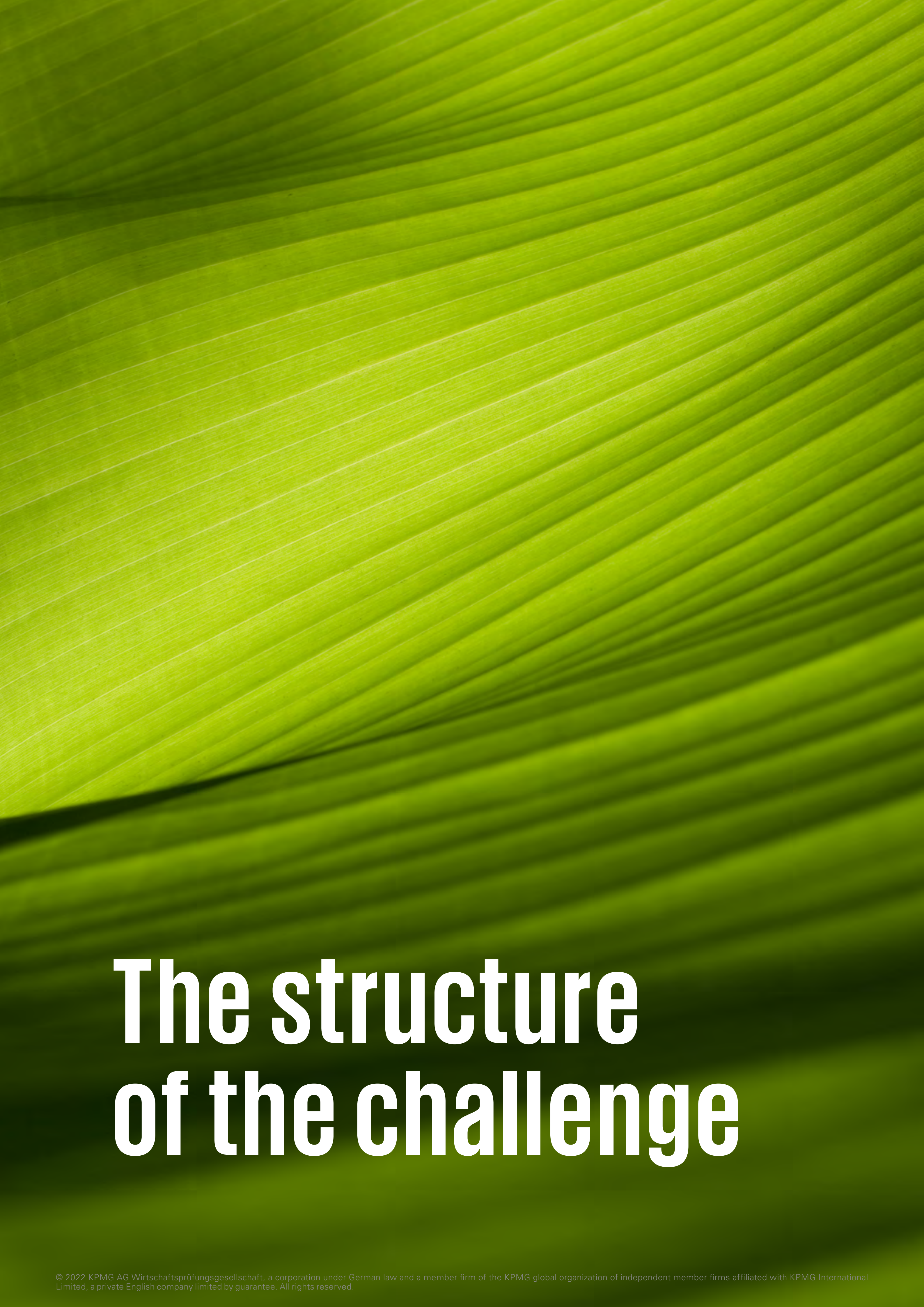
# ESG Risk Management in Banks

Market Survey

# Contents



# The structure of the challenge

# 01
# Background and introduction

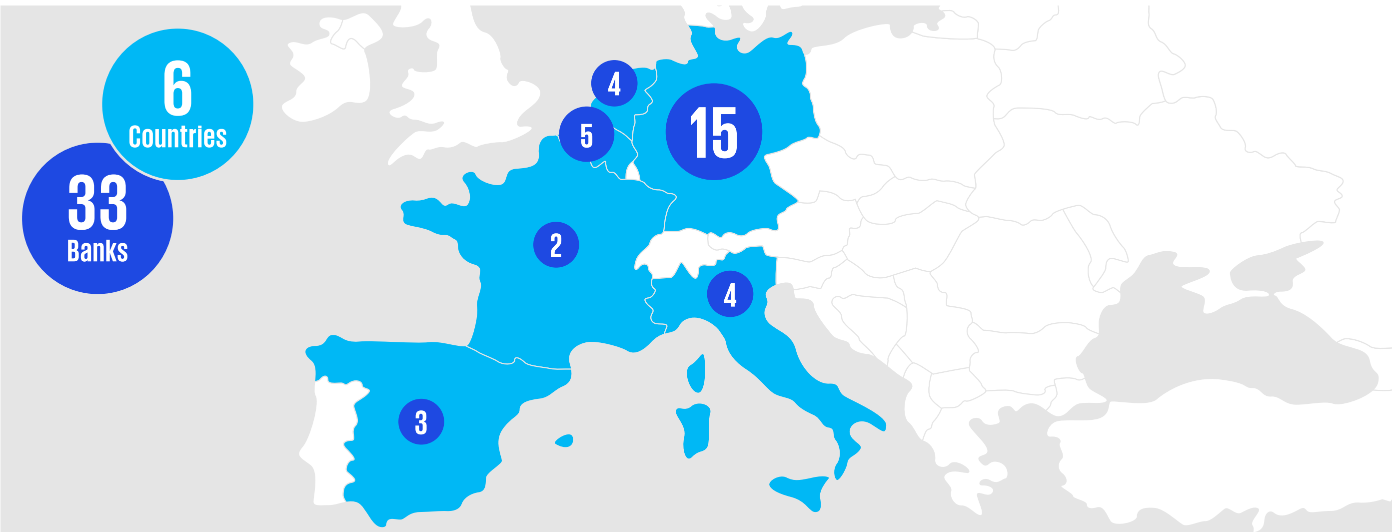
Environmental, social and governance risks, commonly referred to as ESG risks, have received a large amount of attention from supervisory authorities in recent years and have steadily increased in importance in the risk management processes of banks. Many banks have already started integrating these risks into their business models but are facing issues in terms of disclosure and reporting to the relevant authorities, whose requirements have become more strict and more precise.

**Climate and environmental risks are impossible to avoid. The public knows it and the ECB knows it.[1]**

**Frank Elderson**

For instance, the EBA's report from 2021[2] provides institutions with a common definition of ESG risks and their impact channels, while identifying necessary assessment methods required for effective risk management. As described in the ECB's Guide[3] on Climate-Related and Environmental Risks (2020), institutions should include ESG risks as drivers of existing risk categories in their risk management and improve their climate and environment-related disclosures.

But what is the situation in reality? Were the banks able to implement these regulatory expectations into their risk management? In the beginning of 2022 the ECB carried out a "thematic review" on climate related and environmental risks, for all significant financial institutions (SIs). To accompany this process and to provide insights for the participating banks, KPMG set up a benchmark questionnaire that was based strongly on the ECB's survey while also covering additional topics. A special focus of the questionnaire lies on the fulfillment of the **ECB's 13 expectations on climate-related and environmental risks** in the areas of **Strategy and Organization**, **Overarching Risk Management & Framework**, **Internal and External Reporting**, as well as **Risk Type Specific Expectations.**




*Source: KPMG AG Wirtschaftsprüfungsgesellschaft*

[1] *Elderson, Frank: Towards an immersive supervisory approach to the management of climate-related and environmental risks in the banking sector. February 18, 2022*
[2] *EBA's Report on Management and Supervision of ESG Risks for Credit Institutions and Investment Firms (2021)*
[3] *ECB Guide on climate-related and environmental risks 2020*

# ECB's "13 expectations"

## Strategy and Organization

1. Understand the impact of climate-related and environmental risks on the **business environment** to be able to make informed strategic and business decisions

2. Integrate climate-related and environmental risks into the **business strategy**

3. Responsibility of the **management body** for the integration and oversight of climate-related and environmental risks

4. Explicitly include climate-related and environmental risks in their **risk appetite** framework

5. Assign responsibility for the management of climate-related and environmental risks within the **organizational structure** in line with the 3LoD


## Overarching Risk Management & Framework

7. Incorporate climate-related and environmental risks as drivers of established risk categories into their existing **risk management framework**

11. **Scenario analysis & stress testing:** Evaluate appropriateness and incorporate climate-related and environmental risks into baseline and adverse scenarios


## Internal and External Reporting

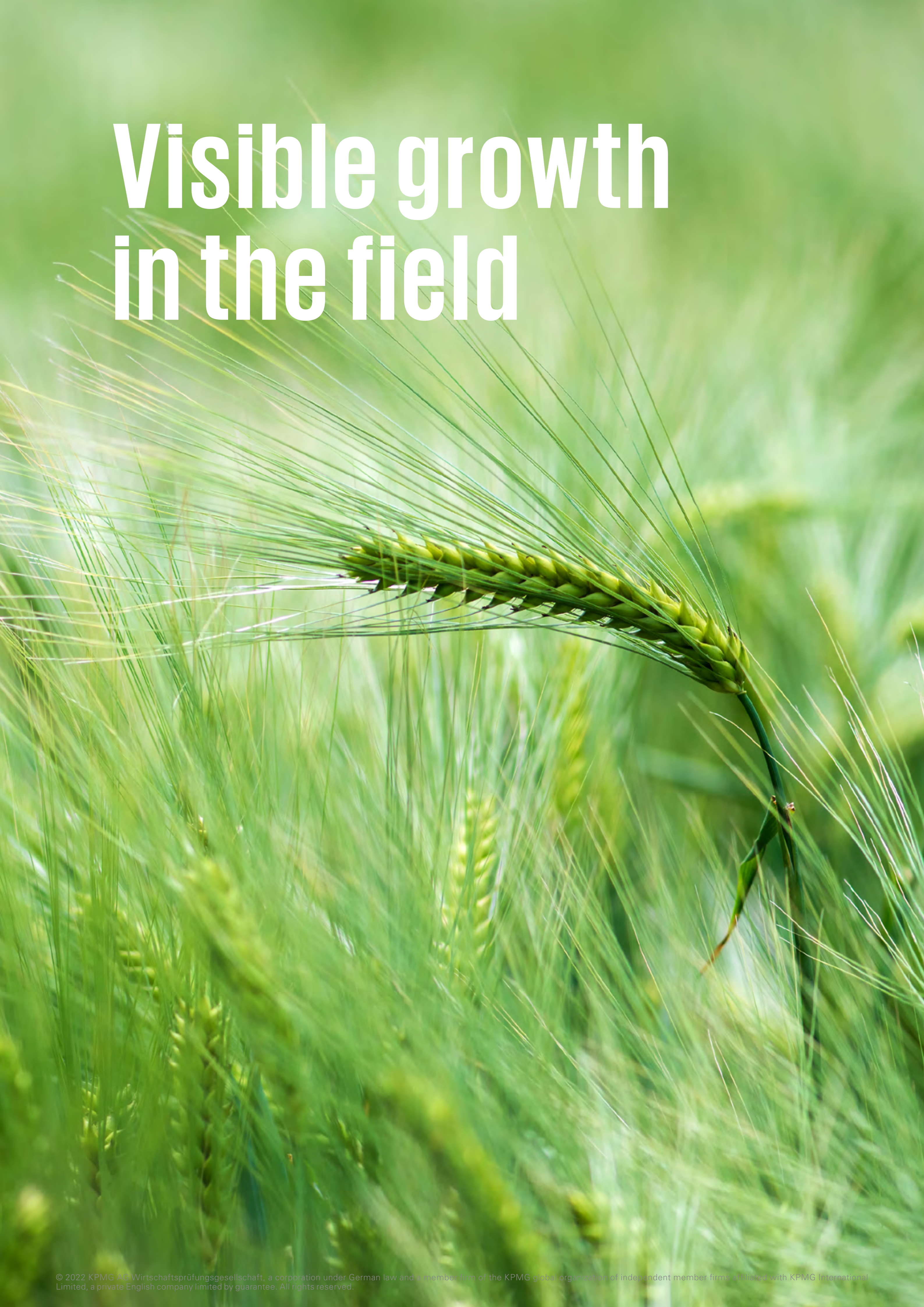
- **6** Reflect exposures to climate-related and environmental risks in the internal **reporting** to management
- **13** **Disclosure policies & procedures:** Publish meaningful information and key metrics on climate-related and environmental risks

## Risk Type Specific Expectations

- **8** **Credit risk:** Consider climate-related and environmental risks at all stages of the credit-granting process and in monitoring portfolios
- **9** **Operational risk:** Consider the adverse impact of climate-related events on business continuity and on reputational and/or liability risks
- **10** **Market risk:** Monitor the effect of climate-related and environmental factors and develop appropriate stress testing scenarios
- **12** **Liquidity risk:** Incorporate climate-related and environmental risk factors into liquidity risk management and liquidity buffer calibration

**The focus of KPMG's survey is on the ECB's 13 expectations for ESG risk management and banks and the progress with respect to implementation**

# Visible growth in the field

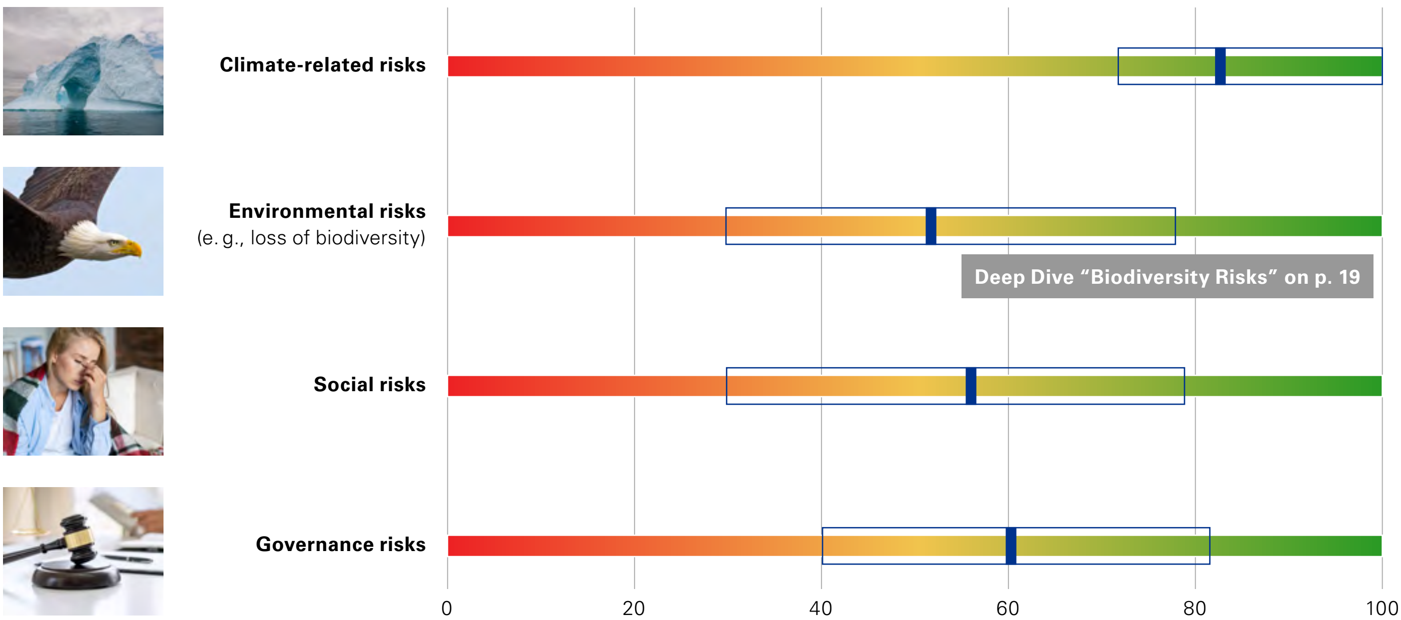


# 02
# Management Summary

Overall, banks have given an particularly **high priority to climate-related risks**, while the prioritization given to environmental risks (e.g., loss of biodiversity), social risks and governance risks is lower and varies widely between banks. A possible explanation is the more complex cause-and-effect relations of these topics compared to climate-related risks, which may make them more challenging for banks to understand and establish them into their risk management.

The consideration of ESG Risk into the overall Governance of the bank is perceived challenging, while at the same time being is one of the top priorities for the participating banks. A similarly high priority is given to the definition of clear responsibilities and the integration of ESG factors into the Three Lines of Defense (3LoD), which is viewed as less challenging. Participating banks appear to be struggling with the definition for risk indicator frameworks, risk appetite, and reporting frameworks.

**Prioritization across governance, social and environmental risk drivers**

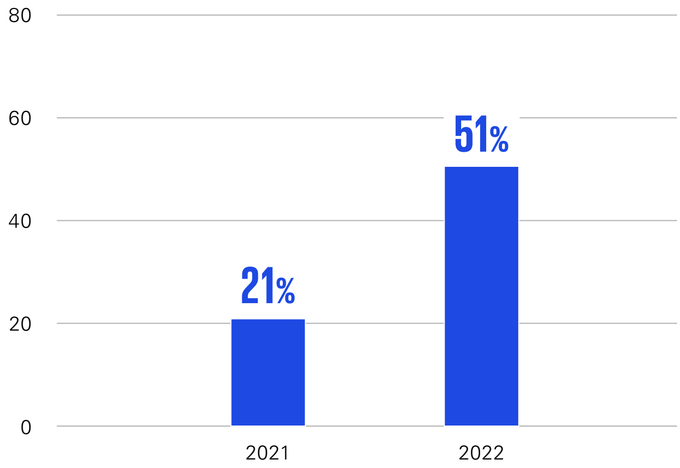



*Source: KPMG AG Wirtschaftsprüfungsgesellschaft*

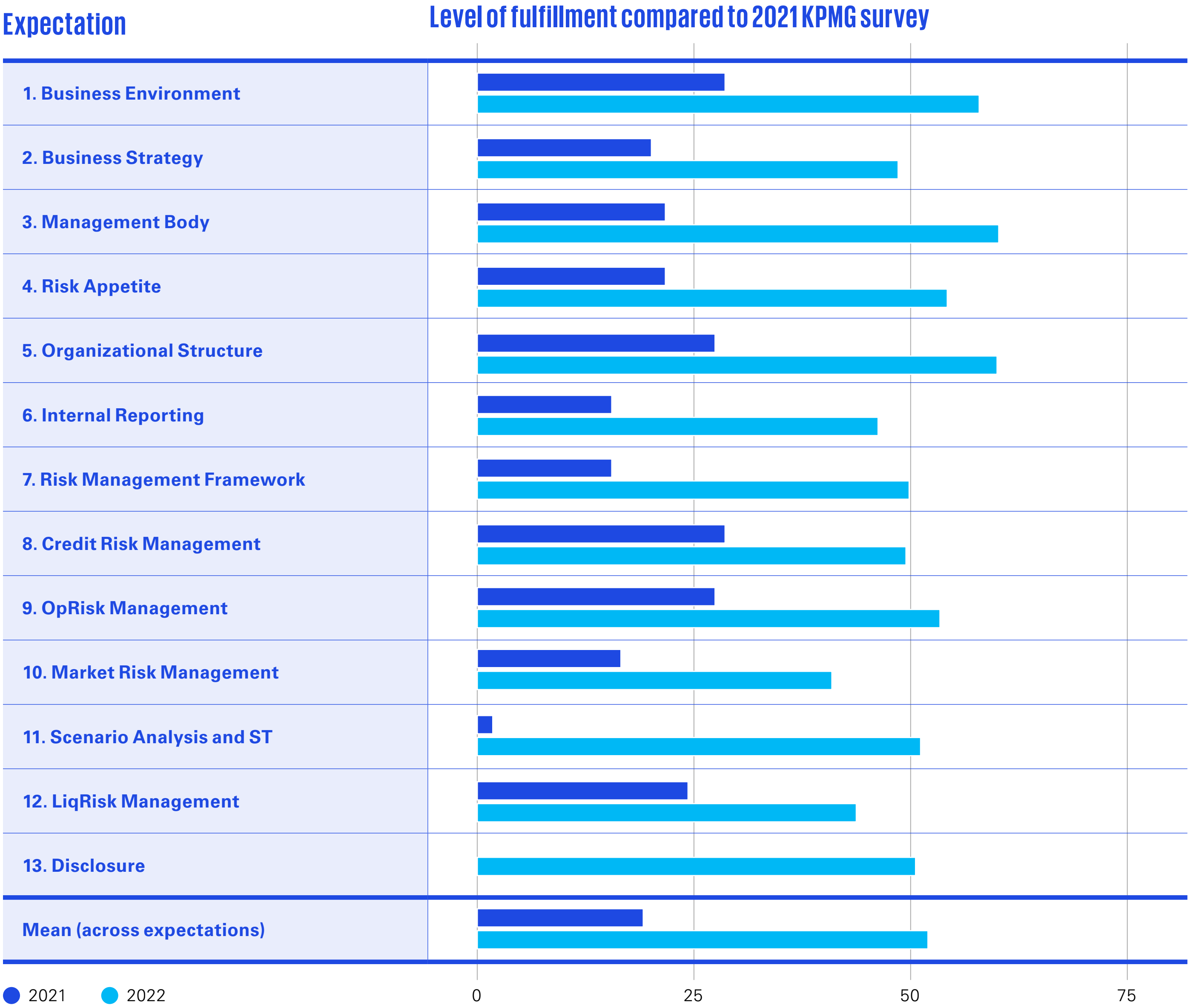
Banks were also asked to rate their degrees of fulfillment regarding the ECB's 13 expectations. There have been strong developments since 2021, especially in Scenario Analysis & Stress Testing.

One development which stands out is the **increased perceived fulfillment of these expectations overall**, from 19% on average in 2021 (a result of KPMG's previous questionnaire on the topic) **to 51% in 2022**.

**Average degree of fulfilment**




*Source: KPMG AG Wirtschaftsprüfungsgesellschaft*




*Source: KPMG AG Wirtschaftsprüfungsgesellschaft*

Full compliance with most expectations is expected by the majority of participants by 2025.

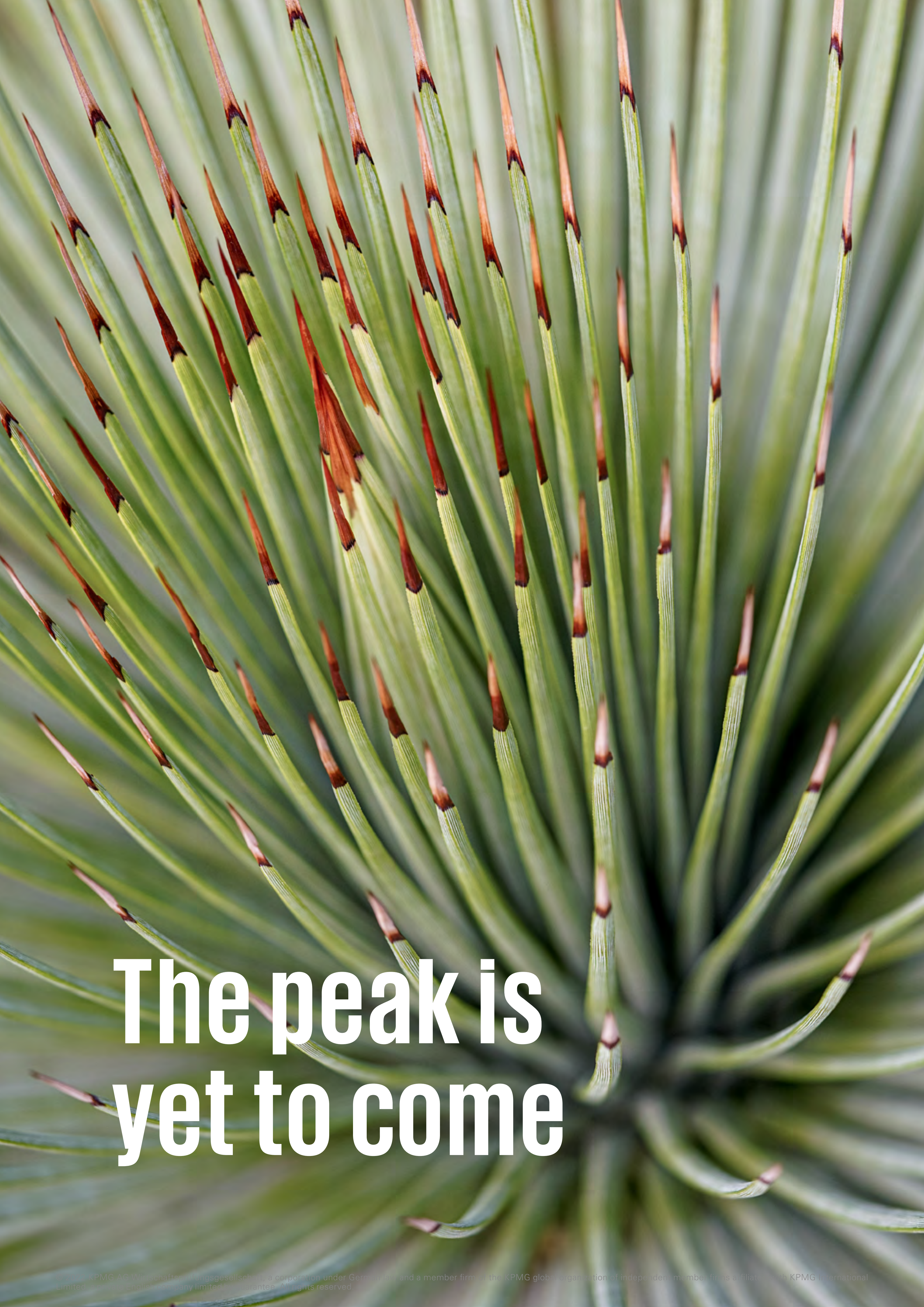
Approximately ¼ of participating banks have achieved the desired level of fulfillment in several expectations.

| 5 | 6 | 20 | 2 |
|---|---|---|---|
| **Already achieved** | **Within 2022** | **Within the next 2–3 years** | **Within >3 years** |

*Source: KPMG AG Wirtschaftsprüfungsgesellschaft*

| | Already archieved | Within 2022 | Next 2–3 Years | > 3 years |
|---|---|---|---|---|
| **1. Business Environment** | 5 | 10 | 17 | 1 |
| **2. Business Strategy** | 2 | 5 | 26 | 0 |
| **3. Management Body** | 9 | 11 | 13 | 0 |
| **4. Risk Appetite** | 4 | 10 | 19 | 0 |
| **5. Organizational Structure** | 7 | 14 | 12 | 0 |
| **6. Internal Reporting** | 3 | 5 | 21 | 4 |
| **7. Risk Management Framework** | 5 | 4 | 22 | 2 |
| **8. Credit Risk Management** | 5 | 5 | 20 | 3 |
| **9. OpRisk Management** | 6 | 3 | 22 | 1 |
| **10. Market Risk Management** | 3 | 4 | 23 | 3 |
| **11. Scenario Analysis and ST** | 6 | 6 | 19 | 2 |
| **12. LiqRisk Management** | 5 | 1 | 25 | 2 |
| **13. Disclosure** | 6 | 5 | 19 | 2 |

*Source: KPMG AG Wirtschaftsprüfungsgesellschaft*


The peak is
yet to come

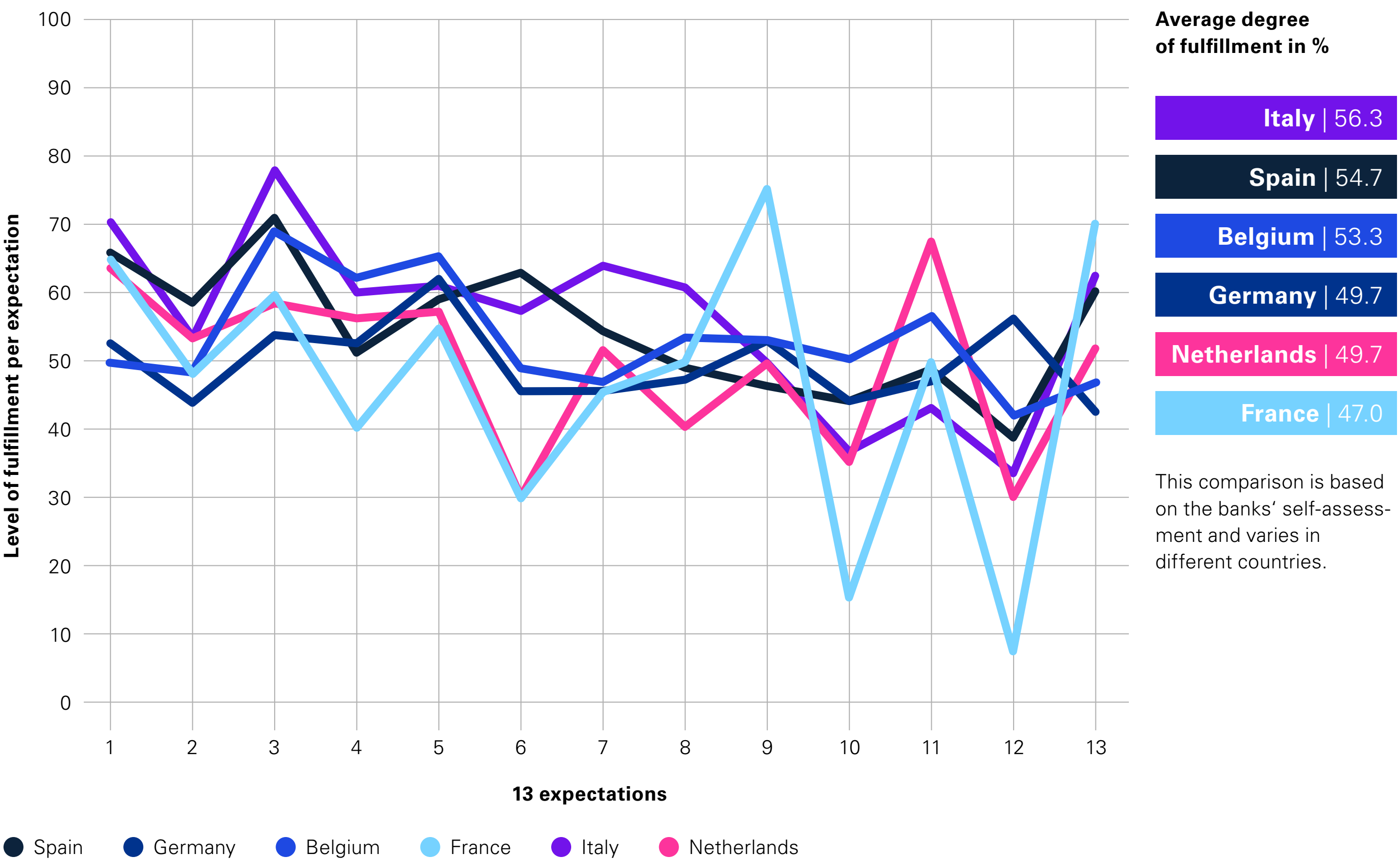
03
# Europe-wide comparison

While Italian banks attest themselves high degrees of fulfillment for many of the ECB's expectations, French banks by their own estimations are lagging behind by nearly 10%. The line chart shows that all participating banks have medium to high degrees of fulfillment regarding strategy and organization (expectation 1 to 5). The biggest potentials for improvement are in reporting (expectation 6) and the integration of ESG into market and liquidity risk models (expectations 10 and 12), which have so far been addressed the least by European banks.

While French banks have an overall low degree of fulfillment, they outperform other banks with regards to ESG risk disclosure (expectation 13). This increased risk awareness can be explained by the "comply or explain" law on climate risks in the financial sector, which was passed in 2015 in France. This obligates listed companies as well as institutional investors and asset managers to disclose their climate-related risks.

All participating banks take climate-related risks seriously. Environmental risks, on the other hand, are currently not prioritized. This may be because banks have not identified the impact of environmental risks such as biodiversity loss on their business or perceive them as far off. In contrast, the effects of climate-related risks can already be observed, such as the Europe-wide catastrophic flood in July 2021, which caused high property damage and cost many lives.

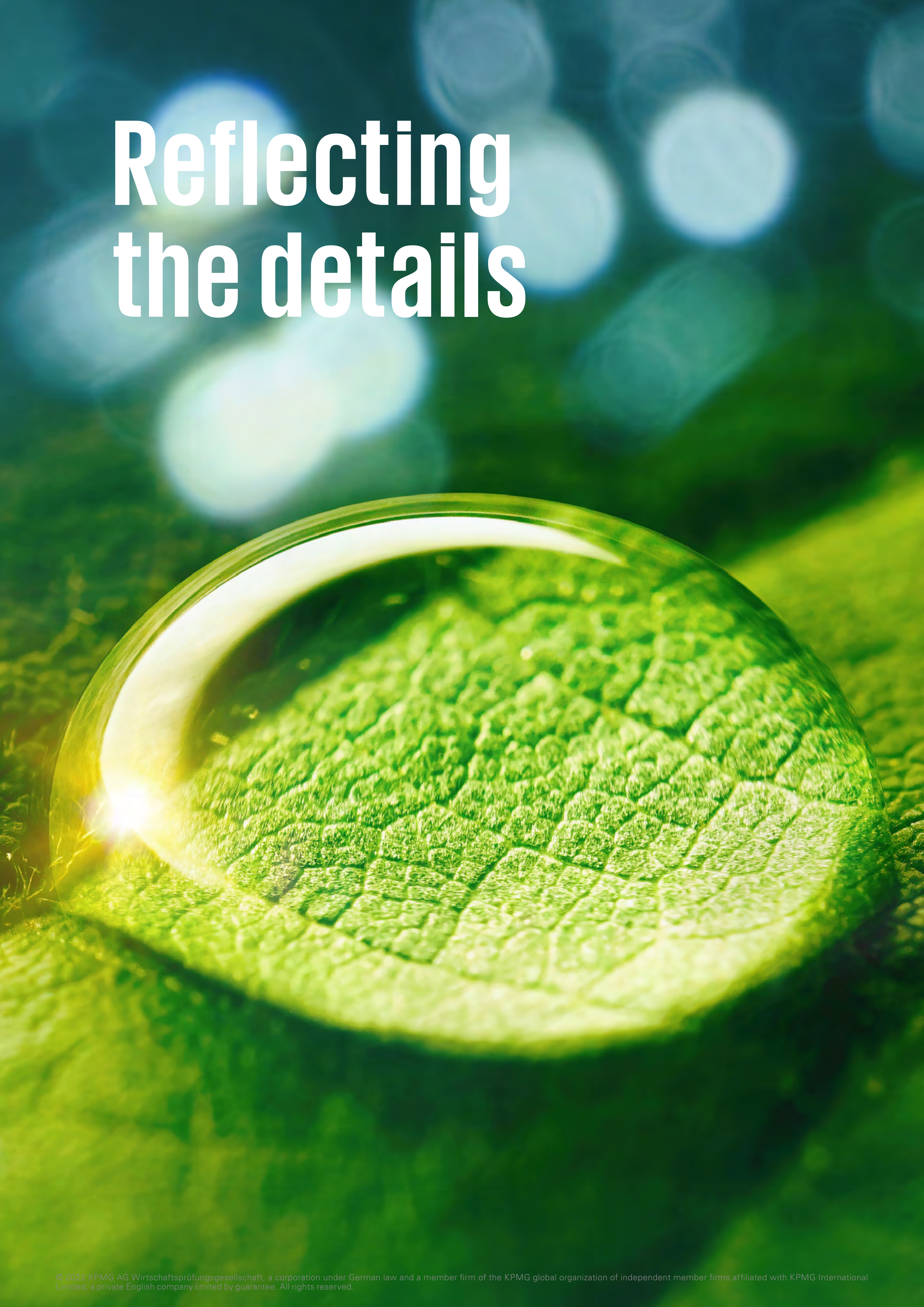
Likewise, social and governance risks are given a lower priority, especially in Germany, France, and Spain. It is unclear, however, whether this assessment is due to a lack of awareness or due to sufficient countermeasures and standards already being in place in these countries.




This comparison is based on the banks' self-assessment and varies in different countries.

*Source: KPMG AG Wirtschaftsprüfungsgesellschaft*

# Reflecting the details



# 04
# Detailed results

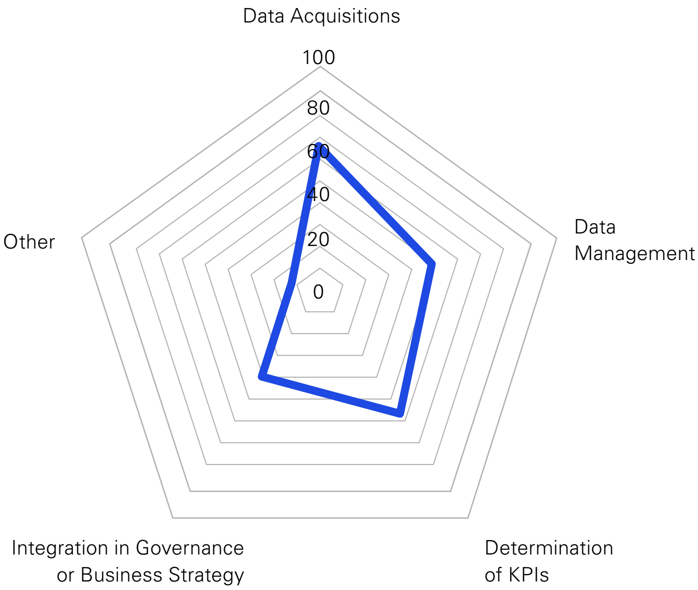
### Strategy and Organization (Expectations 1–5)

The greatest potential for improvement regarding business models and strategy are currently in the areas of data acquisition, data management and the determination of KPIs. Qualitative targets are the most important means of integrating ESG issues into banks' risk strategies. Banks that deal quantitatively with ESG issues use exposure analysis and portfolio alignment assessments for this purpose.

### Internal and External Reporting (Expectations 6, 13)

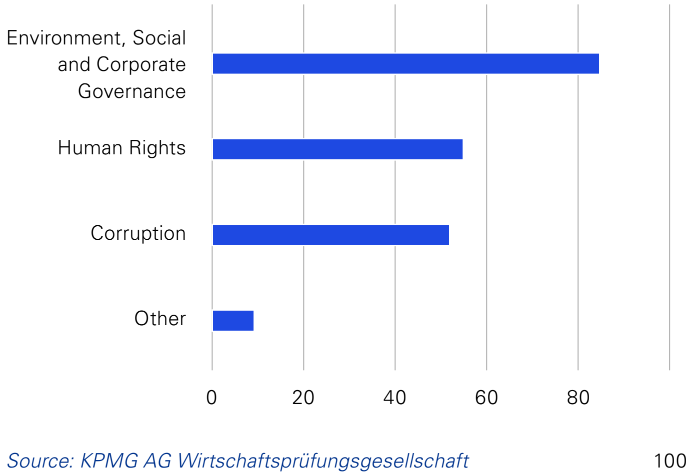
Non-financial statements (NFRD) are the most popular disclosure format. In addition to ESG, corruption and human rights are key issues in non-financial reporting. Qualitative targets are used as relevant metrics in most ESG reports. In April 2021, the EU Commission adopted a proposal for a Corporate Sustainability Reporting Directive (CSRD). With the CSRD, existing rules for non-financial reporting are significantly expanded.

**Largest gaps in Strategy and Organization**




*Source: KPMG AG Wirtschaftsprüfungsgesellschaft*

**Relevant topics on non-financial reporting**



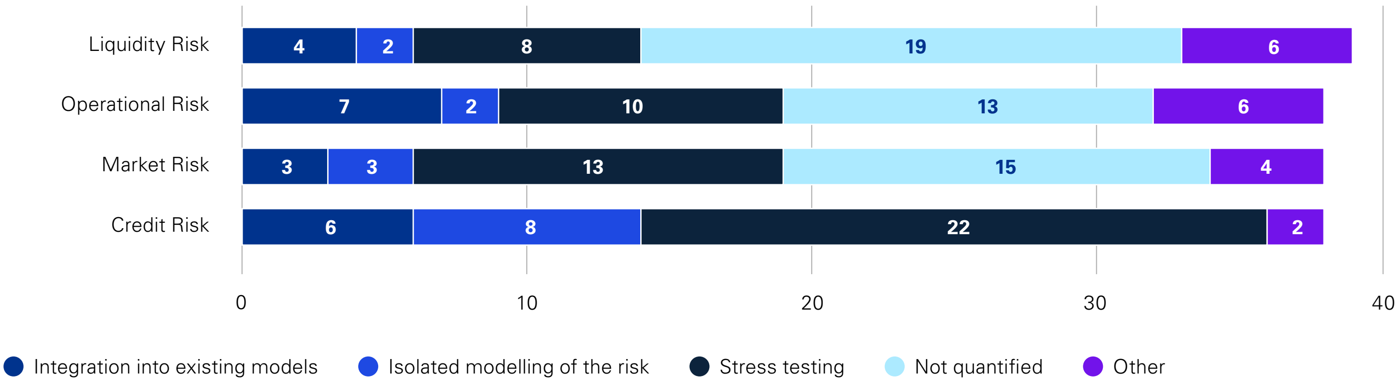

*Source: KPMG AG Wirtschaftsprüfungsgesellschaft*

### Overarching Risk Management & Framework (Expectations 7, 11)

ESG topics are generally viewed as risk drivers rather than as a separate type of risk. ESG risks are therefore mainly quantified by implementing them into existing risk types, either as part of stress tests or by integrating them into existing models. The quantification of ESG risks is not yet fully implemented in all risk types, although credit risk has made first steps in this direction.

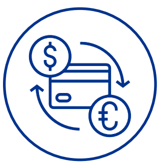
More than half of the banks have already developed KPIs or KRIs for ESG risks. The collection of the necessary data is a central challenge. The main sources for this are third-party commercial data providers, internal counterparty-level data, and external customer data from publicly available sources.

**Frequency of selected risk types (multiple choice)**




*Source: KPMG AG Wirtschaftsprüfungsgesellschaft*

### Risk Type Specific Expectations (Expectations 8, 9, 10, 12)



**Credit risk**

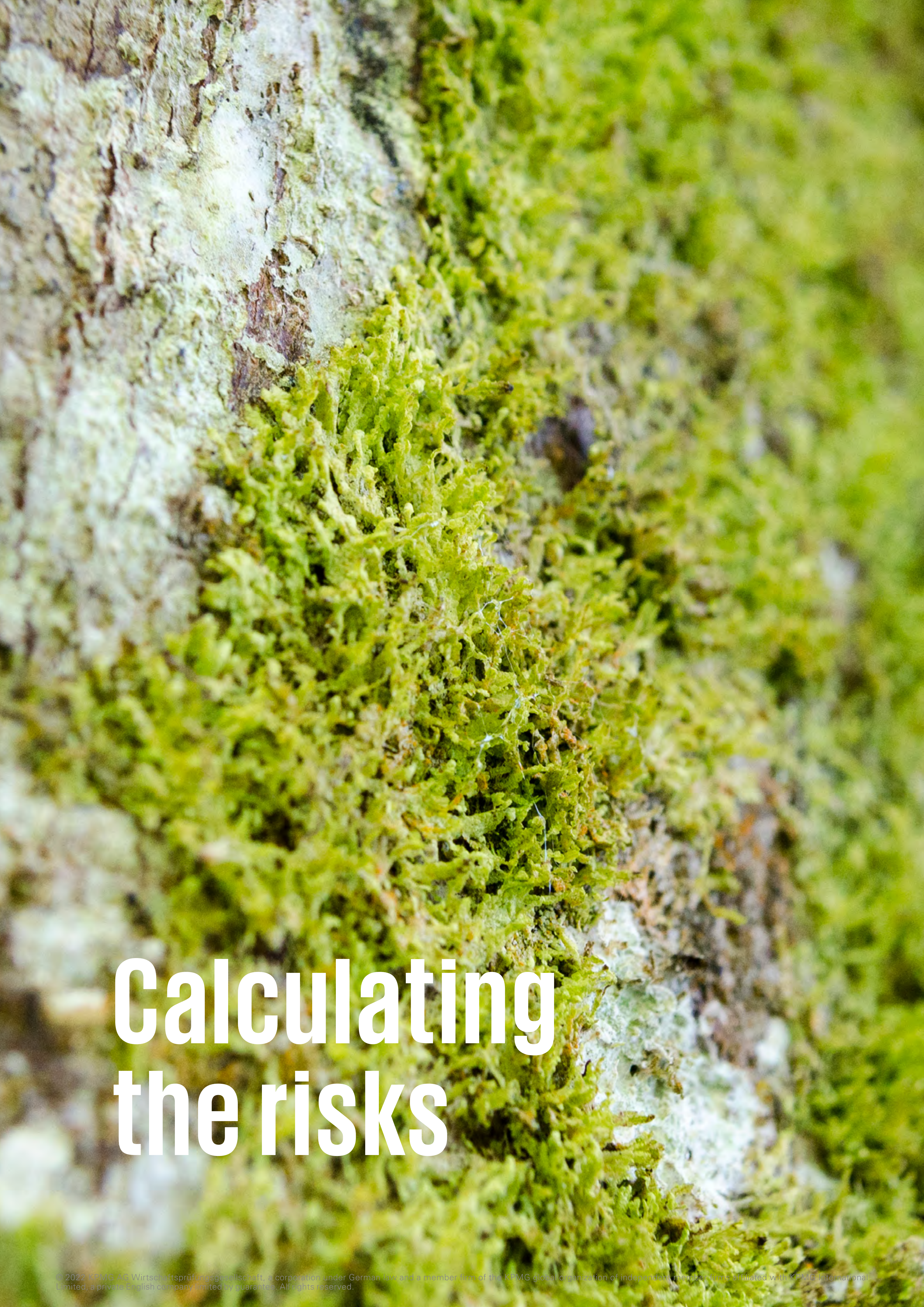
The majority of banks plan to integrate ESG risks into all stages of the credit risk management process, yet ESG risks have been included so far in only five out of ten stages by nearly 40 % of participating institutions; the area with the lowest implementation rate is the integration of ESG risks into the early warnings framework. Within credit risk management, the main challenges relate to the accumulation of ESG data at the customer level.

**Market risk**

Transactions resulting from due diligence and investments, as well as new product approval policies, achieve the highest integration of ESG risks within market risk.

**Operational risk**

Most banks intend to include ESG risks as part of operational risk management, but these have so far not been implemented.



# Calculating the risks

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# Emerging Topic: Biodiversity Risks

There is still little awareness among policy makers regarding biodiversity risks when compared to climate change, especially in terms of mitigation measures, monitoring, data as well as methods and tools to address biodiversity loss. Currently, there are **no scenarios established in the market**, making it **difficult to conduct stress tests analyses**.

While symptoms of climate change such as increasing temperature and sea level rise can all be traced back mainly to greenhouse gas emissions, biodiversity loss consists of interdependent factors such as species extinction and ecosystem destruction and therefore cannot be reduced to a single metric. It also needs to be recognized that climate change mitigation technologies like dams or seawalls can have a negative impact on biodiversity. Thus, biodiversity loss is much harder to measure and prevent.

The primary **drivers** that promote biodiversity loss are **land-and sea-usechange** (e.g., deforestation, tourism, economic growth, infrastructure), **overexploitation of organisms** (e.g., overfishing, poaching, hunting, reduction of pollinator species), **climate change, pollution** (e.g., emissions, industrial waste, overfertilization, pharma products), and **invasive alien species** (e.g., English ivy, greys quirrel). Resulting **transition risks** are government measures, investments in sustainable technologies, and changing consumer preferences, whereas resulting **physical risks** are natural disasters (e.g. floods, droughts), systemic risks, and health risks. All of these can have negative impacts on credit, market, operational, and liquidity risk.

“

**The World Economic Forum’s 2020 Global Risks Report (GRR) ranks biodiversity loss and ecosystem collapse as one of the top five risks in terms of likelihood and impact in the coming 10 years.[4]**

**The World Economic Forum**

Although efforts to prevent biodiversity loss are already underway, such as the creation of new protected areas in the EU[5], banks still need to understand the impacts on the financial industry and adjust their businesses accordingly.

First approaches are currently derived through **stress testing** (even though scenarios are still rough) and through **other risk management tools** (e.g., prototypical impact channels for the ESG riskprofile) – however, as is to be expected, the development of first solutions is associated with high effort.

One approach to understanding and **measuring** biodiversity risks is the **biodiversity footprint** which can be defined to identify particularly vulnerable or damaging sectors and exposures. The GLOBIO[6] model calculates local terrestrial biodiversity intactness, expressed by the mean species abundance (MSA) indicator, as a function of six human pressures, i.e. land use, road disturbance, fragmentation, hunting, nitrogendeposition, and climate change. Banks may also use the **scenario catalogs of the IPBES**, of which, for example, the **”Rio + 20 scenarios”[7]** can provide initial points of reference for possible **scenario analyses.** A purely qualitative analysis of one or two prioritized risk factors could be carried out with reasonable effort as part of an initial simplified scenario analysis.

[4] *https://www3.weforum.org/docs/WEF_Global_Risk_Report_2020.pdf*
[5] *EU Biodiversity Strategy for 2030*
[6] *https://www.globio.info/*
[7] *https://ipbes.net/sites/default/files/downloads/pdf/SPM_Deliverable_3c.pdf*

# Finding the right distribution

06
# Conclusion

Most banks are focused on climate risks in their risk management while paying less attention to the social and governance dimensions. This must be seen as a shortcoming, as a continued failure to act on these topics will sooner or later lead to a material disadvantage in a regulatory frame that is quickly evolving. A new EU taxonomy on the social sector was recently published which underlines the need for social investments in order to achieve the sustainable development goals (SDGs) of the UN, and create the social internal market set out in the Treaty on European Union. The new Corporate Sustainability Reporting Directive (CSRD) proposal includes detailed disclosure requirements not only on climate risk, but also on environmental, social and governmental risks.

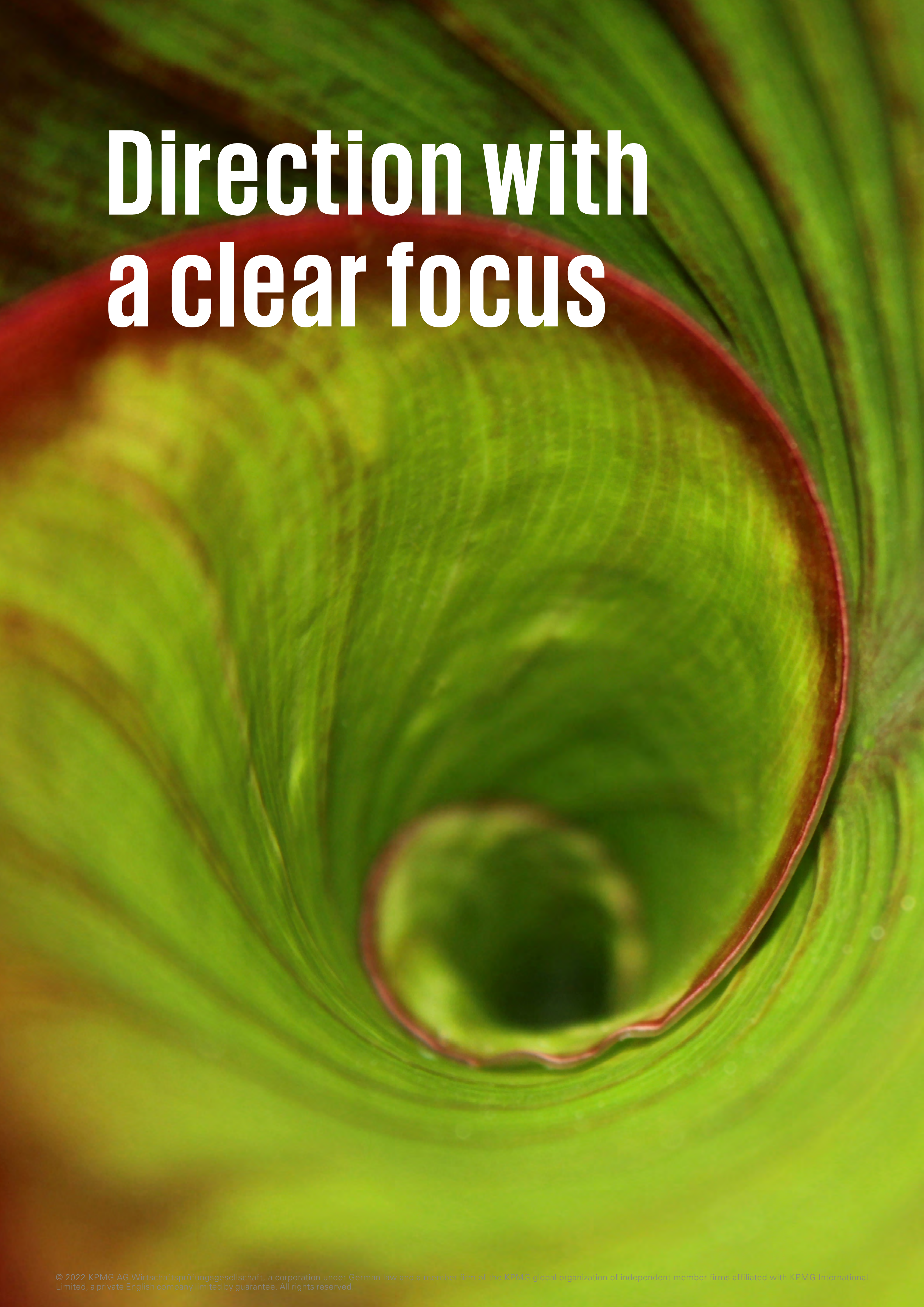
Also, financial institutions need to realize the importance of environmental risks such as a loss of biodiversity and take active measures to incorporate this risk driver in their risk management.

> **We are asking banks to fully grasp the physical and transition risks and to actively start managing them, with the aim of making their portfolios more resilient to C & E risks.[8]**
>
> **Frank Elderson**

In the past year, there have been efforts to approach the topic from the perspective of a bank, e.g., to make loan portfolios analyzable from the perspective of E, S, and G. Banks now need to focus on incorporating liquidity risk and market risk into their models, as has already happened to a larger degree with credit risk and operational risk. Additionally, best practices must be established regarding the quantification and reporting of ESG risks in order to fulfill the ECB's standards.

[8] *Elderson, Frank: Towards an immersive supervisory approach to the management of climate-related and environmental risks in the banking sector. February 18, 2022*

# Direction with a clear focus



# 07
# Outlook

Even though significant progress has already been made, the banks participating in the KPMG study are aware that a considerable number of steps still need to be taken in order to include ESG risk drivers in all parts of their risk management.

The ECB has come to a similar conclusion. It intends to continue analyzing and following the engagement process closely, for instance, in the form of specific case studies conducted with individual banks. The aim of these case studies is to find out whether and to what extent banks have implemented the ESG processes stated in the ECB's survey, how stringently they have been applied to the relevant portfolios, and how they hold up in terms of soundness and comprehensiveness.

The structure of these case studies has been described by the ECB. Starting May 2022, there will be four interviews for each bank supervised directly by the ECB. A longlist of possible portfolios or engagements to be discussed in the interviews for each module and each bank is identified by the Joint Supervisory Teams (JSTs). Finally, the JSTs will determine which exposures are to be discussed in the case studies. The accompanying interviews serve as the basis for a comprehensive feedback letter.

Beyond these case studies, steadily increasing regulatory and supervisory pressure can be expected with the aim of further promoting ESG risk integration. Banks should therefore aim to institutionalize their sustainability management. According to a study by Strategy&, companies that have created the position of Chief Sustainability Officer (CSO) have a better ESG rating on average than those who have not. This in turn affects access to financing and the image of the company in the talent market and the broader public, according to Peter Gassmann, who conducted the study. An important factor in the efficiency of the role of CSO is at which management level it acts. If the CSO is installed at a lower management level, as commonly seen in Switzerland, its influence on the sustainable transformation of the company is limited. The role should not be viewed as an additional task within another division, but instead it should be located centrally with one person at a sufficiently high level.

**Banks are running out of time to complete their preparations. […] The sooner banks act, the smoother the transition will be for them, and for the economy they help support.**

**Frank Elderson**

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