The need to act: Climate and environmental indicators in banks' strategies

The global transition to a more sustainable economy is rapidly changing the market environment for the financial sector underlining the special role banks play. Climate-related and environmental (C&E) risks are becoming an inevitable part of banks' business strategy and risk management framework. To operationalise C&E targets and related risk appetite, financial institutions are mobilising their resources actively working on integrating C&E-related key performance indicators (KPIs) and key risk indicators (KRIs) into their processes. There are many challenges along the way, but EU policymakers and regulators are taking further steps, e.g. imposing disclosure regulations for corporates, to help the financial sector to address capability gaps.

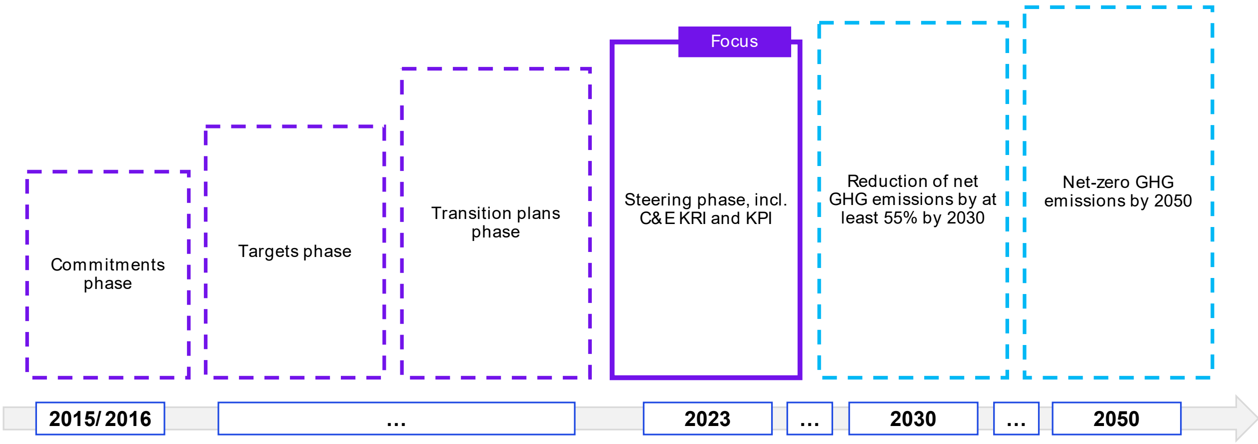
Why is integration of C&E risks in banks' business and risk strategies important?

Under the Paris Agreement, which was adopted at the 21st Conference of the Parties (COP21) in 2015, 196 countries committed to the long-term goal of holding the increase in the global average temperature to well below 2°C compared to pre-industrial levels. To fulfil this commitment, the European Commission (EC) launched the European Green Deal in 2019, and later in 2021, the European Union (EU) adopted European Climate Law[(1)]. In a nutshell, the Climate Law aims to reduce greenhouse gas (GHG) emissions by at least 55 percent by 2030 (following "Fit for 55" proposal[(2)]), with a new reduction target to be set for 2040, and to achieve climate neutrality by 2050 and subsequently negative emissions.

Banks play a pivotal role in the transition, as they can direct markets toward the targets via curbing financing or revising financial instrument pricing, e.g. for limiting brown activities and supporting green activities. At the same time, as bank borrowers are facing ever greater challenges from climate change and environmental degradation, banks will be at the forefront in respect to the impact of C&E risks. To provide a sound regulatory framework for managing C&E risks, European policymakers have developed guidelines that require banks to integrate C&E-specific targets and metrics into business strategy and risk management. In addition to growing regulatory expectations, major banks have announced their own commitments to sustainability, including climate-related, increasing the importance of developing and implementing C&E-related strategies and relevant KRIs and KPIs (Figure 1).

Notes:
(1) Regulation (EU) 2021/1119 of the European Parliament and of the Council of 30 June 2021 establishing the framework for achieving climate neutrality and amending Regulations (EC) No 401/2009 and (EU) 2018/1999 ("Climate Law")
(2) European Commission Communication 'Fit for 55': delivering the EU's 2030 Climate Target on the way to climate neutrality, link: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52021DC0550

Figure 1. Evolution of banks approach towards net zero.



Commitments phase: major banks have announced a commitment to engage in sustainability and to reduce emissions. Targets phase: many banks set up targets to reduce net GHG by at least 55% by 2030 and having net-zero GHG emissions by 2050. Transition plans phase: major players have plans in place on how to achieve those targets, including intermediate goals and timelines. Steering phase, incl. C&E KRI and KPI: banks have been working, including development of KRIs and KPIs as the main tools, to achieve ECB's expectation to manage C&E risks with an institution-wide approach covering business strategy, governance and risk appetite, as well as risk

Source: KPMG in Germany, 2023

What is the regulatory background for integrating C&E indicators?

In the EU, banks are guided mainly by the following sources of regulations and guidelines when establishing KRIs and KPIs:

- **ECB Guide on climate-related and environmental risks** expects the larger banks directly supervised by the ECB to explicitly include C&E risks in their risk appetite framework (RAF) (Expectation 4), to use KRIs and KPIs for internal monitoring and reporting to management (Expectations 3), and to cascade KPIs down to the C&E risk-material portfolios (Expectation 2) by the end of 2023. After conducting thematic reviews, ECB released reports(3) and good practice observations(4), providing examples on how financial institutions can align their practices with supervisory expectations.

- **EBA Report on management and supervision of ESG risks for credit institutions and investment firms** prescribes banks to proactively introduce ESG-specific risk metrics and limits for regular assessment of portfolio risk profiles and for reviewing investment strategies. However, the EBA does not define hard deadlines for implementation of the requirements.

- **Local central banks and regulators of EU countries** also set requirements on their level, e.g. German BaFin introduced requirements on C&E KRIs in the 7th amendment of MaRisk(5) (in consultation until October 2022) as well as in the Guidance notice on dealing with sustainability risks(6) published in January 2020 for immediate implementation).

To ensure banks take necessary actions on the C&E risk integration in the strategy and risk management the regulators may use supervisory measures, including capital add-ons. For instance, at the outcome of the 2022 supervisory exercises on C&E risks, a small number of banks had their capital requirements (via Pillar 2, SREP scores) raised by the ECB(7). This, along with existing sustainability commitments and reputational concerns, emphasises the importance of implementing changes within the timeline specified by regulators.

What are the challenges observed for implementing C&E indicators and initiatives to address them?

The ECB Thematic Reviews based on the assessment of 112 significant institutions (SIs) in 2021 and 186 institutions (107 SIs and 79 less significant institutions (LSIs)) in 2022 show the limited progress on implementing C&E KPIs and KRIs. In 2021 less than 20% of banks included C&E KRIs in their risk appetite statement, by 2022 around 66 percent of institutions had an initial set of KRIs. Whereas still a third of institutions have yet to make the first step of setting KRIs in 2023, for those two-thirds that have already done this step, an enhancement of KRIs is required. Specifically, the ECB reviews underline where KRIs are already in place: (1) these are mainly of a qualitative nature, suggesting the necessity of adding quantitative KRIs, (2) focus mostly on transition risks, implying the importance of having also physical risk related KRIs in

(3) Thematic Review 2021: The state of climate and environmental risk management in the banking sector Report on the supervisory review of banks' approaches to manage climate and environmental risks, ECB, November 2021 (Thematic review 2021). Walking the talk Banks gearing up to manage risks from climate change and environmental degradation Results of the 2022 thematic review on climate-related and environmental risks, ECB, November 2022 (Thematic review 2022) (together – Thematic reviews)
(4) Good practices for climate-related and environmental risk management. Observations from the 2022 Thematic Review, ECB, November 2022 (Good Practices)
(5) Entwurf der Änderungsversion zu den Mindestanforderungen an das Risikomanagement, BaFin, September 2022 (MaRisk)
(6) Guidance notice o n dealing with sustainability risks, BaFin, January 2020 (Guidance Notice)
(7) Task Force on Climate-related Financial Disclosures 2022 Status report, October 2022 (TCFD Status Report 2022)

place, and (3) lack of granularity, recommending more granular indicators.

In addition, the 2022 Thematic Review showed that 74 percent of significant institutions under assessment had started to determine the C&E risks impacting on their business strategy and established an initial set of C&E KPIs. Furthermore, around 14% of the institutions had sufficiently developed processes in place that allow them to take corrective action when KPIs are not achieved. LSIs have also made progress in incorporating climate-related risk considerations into the strategy process.

As observed by our KPMG professionals, financial institutions face various challenges for operationalizing their C&E commitments:

- **Challenges relating to C&E data availability**
  Client-level C&E data may not be available to a bank if the client does not disclose such information. Banks may consider the use of proxied C&E data until disclosure requirements, such as corporate C&E disclosure (CSRD), to improve their access to granular client-level data.

In addition, the Sustainable Finance Disclosure Regulation (SFDR) was introduced by the European Commission in March 2021, with an implementation date in January 2022. SFDR imposes comprehensive sustainability disclosure requirements covering ESG metrics at both entity and product level.

Furthermore, the EU Taxonomy regulation, which entered in force in July 2020, requires large financial and non-financial institutions to publish performance indicators related to their alignment with the taxonomy criteria. Full implementation of the requirements should have been completed by January 2023. TCFD Status Report 2022 indicated progress among the analysed companies, including financial institutions, on aligned disclosures on credit-related targets from 27 percent in 2019 to 45 percent in 2021. **Further improvements**, as a result of the regulations and commitment of companies and financial institutions, **are expected in the upcoming years.**

Meantime, certain C&E-related data is already available to banks yet scattered across the institution. Thus, the TCFD Status Report 2022[8] showed that banks have been one of the sectors with the lowest adoption and disclosure of climate-related metrics and climate-related targets. Disclosure requirements directed towards banks, e.g. EBA's ESG Pillar 3 requirements, will help banks to mobilise their efforts for enhancing C&E data integration.

- **Substantial governance challenges when executing the C&E risks action plans**
  The ECB's review showed that 55 percent of institutions had developed practices but failed to implement them effectively. Thus, most institutions had formulated C&E KRIs and KPIs, but seldom cascaded them down to business lines and portfolios, while a clear framework for corrective action is frequently absent.

- **Deficiency of C&E-knowledgeable resources or low appreciation of resource needs**
  Lack of resources with adequate knowledge in the C&E area, including comprehensive understanding of the nature of C&E risk drivers and the impact of these on a bank's portfolio, may play a significant role in not making substantial progress on C&E action plans.

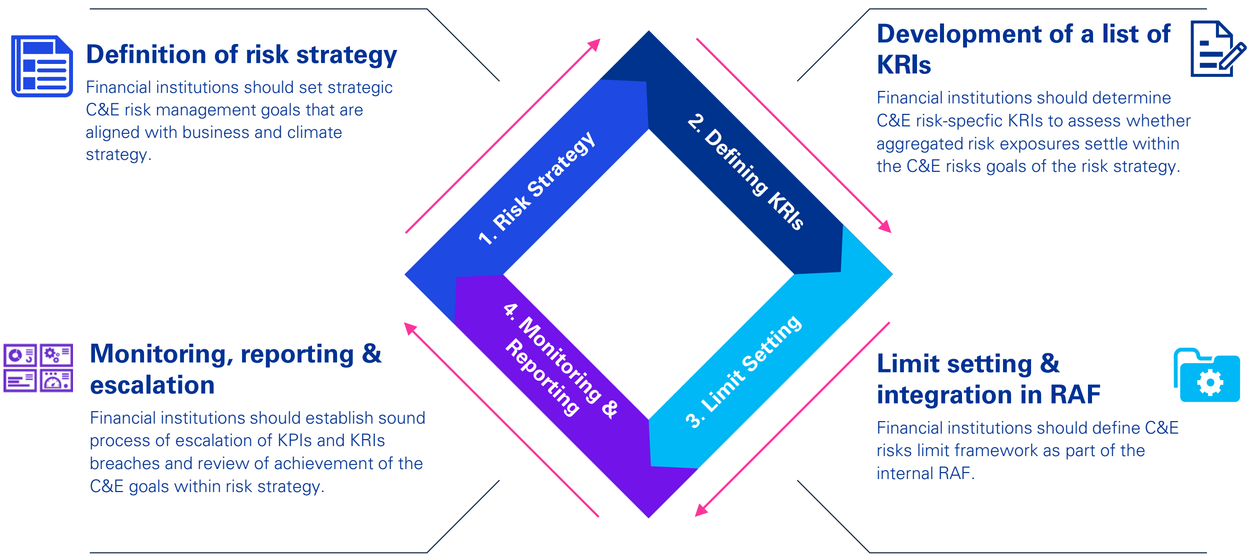
(8) Final draft implementing technical standards on prudential disclosures on ESG risks in accordance with Article 449a CRR, EBA, January 2022

Although the authorities have been improving regulatory frameworks on data governance and architecture, other issues, including improving execution governance on C&E KPIs and KRIs and developing expertise of staff and management in ESG matters, still require significant efforts from the financial institutions[9].

What steps are mature banks taking now to introduce C&E indicators?

Taking into account current market practices, our KPMG professionals define four key steps for operationalizing C&E commitments (Figure 2):

Figure 2. Stylised example of setting up KRIs and KPIs.



Interactive process starts with risk strategy. Banks need to determinate C&E KRIs specific to the business model, related KPIs and the chosen risk strategy. These C&E KRIs are used as a basis for setting risk limits and later for monitoring and reporting strategy implementation (with escalation to the management, when required). Banks may need to amend the strategy based on observations from implementation.

Source: KPMG in Germany, 2023

1. Definition of risk strategy for C&E risks: After carrying out a materiality analysis on the existing risk taxonomy, mature financial institutions decide on strategic C&E risks management goals. The goals are aimed to be aligned with business strategy as well as climate strategy and KPIs. Financial institutions should use KPIs to measure performance of staff, business units, and projects against their strategic goals and business strategy.

2. Defining C&E-related KRIs: KRIs are risk measures that represent a financial institution's risk capacity and help assess whether financial institutions gross and net risk exposures aggregated within and across each relevant risk category are within the risk strategy. The definition of C&E KRIs includes four steps. (1) Determination of C&E risk categories which are in scope: climate-physical, climate-transition, environmental non-climate. (2) Definition of the scope for lending and investment exposures. (3) Designing a long list of potential KRIs to track the goals. (4) Prioritisation and selection of the most relevant KRIs.

3. Limit setting & integration of C&E KRIs in RAF: Advanced financial institutions create C&E risks limit framework as part of the internal RAF.

4. Monitoring, reporting & escalation of C&E KPIs and KRIs: Financial institutions establish sound internal monitoring processes with clearly defined reporting frequency and escalation of C&E KPIs and KRIs to relevant stakeholders. Roles and responsibilities, action points as well as approval process should be determined within the escalation process. Monitoring whether climate-related risks align with the bank's risk strategy through KRIs can be done at portfolio and individual client level.

In order for C&E KRIs and KPIs to be an effective management tool, it is crucial to establish forward-looking, higher-resolution quantitative and qualitative indicators at portfolio level, with well calibrated limits and thresholds as well as clear mitigation actions in escalation procedures.

(9) Please see more details [Transparenz von ESG-Risiken: Wo Finanzinstitute heute stehen (kpmg.de)]

Examples of C&E KPIs and KRIs

KPMG's project experience and ECB observations on good practices show that mature banks not only introduce various C&E KRIs and KPIs, but also ensure interconnection between them to effectively achieve targets within a transition trajectory, e.g. reduction of emissions intensity (Figure 3).

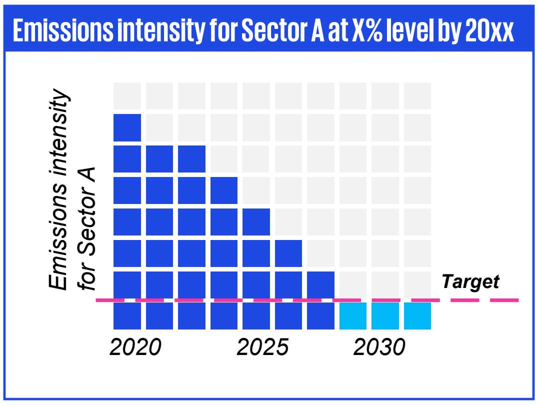
Figure 3. Example of interrelation of KRIs and KPIs reflecting a transition trajectory

Key Risk Indicator

KRI measures the emissions intensity of bank's exposures to certain sectors. A KRI breach is triggered when emissions intensity exceeds the alignment trajectory (limits).

Key Performance Indicator

KPI reflects percentage of emissions intensity reduction in portfolio. KPI is integrated in remuneration policies.



Notes: Banks may integrate a transition trajectory to achieve the net-zero GHG emissions target. In this case, KRIs reflect the target level of emissions intensity. KPIs now reflect the specific percentage reduction of the emissions over a defined period. The KRIs and KPIs would be relevant for portfolios which are mostly affected by transition risks: energy, manufacturing, construction, transport, mining and extractive industries.

Source: KPMG in Germany, 2023

Other examples of C&E KRIs and KPIs that advanced banks introduce into business strategies and risk management are designed to reduce the C&E risk level at overall portfolio level, at the level of sectors and geographies, or considering size of bank's operations. Examples of KRIs and KPIs are presented in Table 1.

Table 1. Examples of C&E KRIs and KPIs

Examples of KRIs	Examples of KPIs
Portfolio level • An indictor in RAF showing volume of financed emissions in the lending and investment portfolios.	• Financed emission reduction targets at portfolio level. • Set amount of issued "sustainable" or "green" finance products. • Variable remuneration incentive triggered based on the number of science-based targets. • Predefined milestones as per C&E risk management strategy (e.g. adopting certain policies within the institution). • Predetermined level of sustainability ratings from a set pool of rating agencies.
Per sectors/geography • Absolute limits for credit risk exposures relating to sectors and/or geographies subject to elevated C&E risks (both transition and physical risk drivers). • Relative limits for credit risk exposures relating to sectors and/or geographies subject to elevated C&E risks (both physical and transition risk drivers). Limit is a percentage of all corporate exposures. Besides the limit, banks define predefined attention thresholds. • (Minimum) limits and attention thresholds based on percentage of companies classified as low-emitting in the portfolio.	
Bank's operations • Limit reflects physical impact of C&E changes on the institution's operations. Limit level is based on historical losses and scenario analysis for future impact.	

Source: Based on ECB Good practices 2022

Furthermore, advanced banks with substantial exposures to the sectors exposed to environmental risks (agriculture, forestry, fisheries and livestock) pay special attention when defining and steering environmental risks-related KPIs and KRIs[10].

(10) Please see also https://kpmg.com/be/en/home/insights/2023/01/ba-loss-of-biodiversity-the-twin-risks-of-climate-change.html

What do banks gain from integration of C&E indicators into business and risk strategy?

With the integration of C&E KPIs and KRIs into risk management practices and business strategy, banks can better navigate towards their C&E targets, such as GHG emissions reduction. Cascading the indicators to the business lines increases awareness of the strategic targets and creates a basis for well-informed decisions, particularly in credit lending. Banks that set C&E targets in close collaboration with risk management gain more tangible insights for managing C&E risks and are better able to assess and manage the potential impact of C&E events on their operations.

Conclusion

Financial institutions play a decisive role in the global transition to a more sustainable economy. Integrating C&E risks in banks business and risk strategy requires significant efforts from the banking sector due to the existing challenges, such as availability and consistency of C&E-related data. Proactive integration helps financial institutions better navigate towards their C&E targets and strengthen their decision-making process, particularly in credit lending. Regulators and supervisors have launched several initiatives and guidelines, to help banks in this journey to meet all requirements.

There are several ways to embed C&E-specific KPIs and KRIs into the risk management framework, and a holistic approach is key to building a more profound, efficient, and sustainable risk management function.

This article has been written by Alsu Yambaeva, Olha Boiko, Evgeniya Krivtsova, Armina Schädle.

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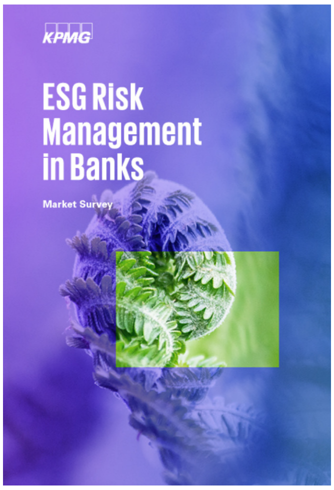
More Insights



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Contact

KPMG AG
Wirtschaftsprüfungsgesellschaft

The Squaire/Am Flughafen
Frankfurt am Main, 60549

Alsu Yambaeva
Manager
T +49 69 9587-3833
ayambaeva@kpmg.com

Evgeniya Krivtsova
Senior Specialist
T +49 69 9587-3395
evgeniyakrivtsova@kpmg.com

Clemens Wieck
Senior Manager
T +49 40 32015-4089
cwieck@kpmg.com

Armina Schädle
Manager
T +49 30 2068-3813
aschaedle@kpmg.com

Katia Vozian
Senior Manager
T +49 69 9587-1620
evozian@kpmg.com

www.kpmg.com

home.kpmg/socialmedia