Financial Risk&Regulation

ESG readiness in the EU, the impact of the changing economic environment on ESG

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Among the most important risk management and regulatory trend over the past year for banks has been the implementation of new processes and controls related to ESG investments, risks, and sustainable finance. KPMG conducted a market survey of 33 banks in six countries on the status of compliance with the European Central Bank's (ECB) 13 corresponding expectations, and looked at how ESG processes may be affected by rising geopolitical risks. The full survey is available here.

The European Central Bank's 13 expectations

The ECB's 13 expectations, similar to the National Bank of Hungary's (NBH) Green Recommendation which we previously wrote about here, set out expectations for banks in 13 key areas. These 13 areas are Business Environment, Business Strategy, Management, Risk Appetite, Organizational Structure, Reporting, Risk Management Framework, Credit Risk Management, Operational Risk Management, Market Risk Management, Scenario Analysis and Stress Testing, Liquidity Risk Management, and Publication and Related Rules.

The topic of strategy and organization covers five areas. Regarding business environment, ECB expects banks to understand the impact of climate and environmental risks on the business environment to make informed strategic and business decisions. Moreover, it is necessary to incorporate climate and environmental risks into business strategy. Furthermore, it is important for senior management to take responsibility for monitoring climate change risks and for integrating them into business processes, by taking climate and environmental risks into account when determining risk appetite. Responsibility for climate and environmental risks should be allocated to management according to the triple line of defense within the organizational structure.

Expectations are detailed for both external and internal reporting, within two major areas: reports and publications. In order to provide management with adequate and regular information, it is important that internal reports reflect exposures to climate and environmental risks. In addition, there is a legal obligations to comply with publication guidelines (e.g. the new Pillar 3 publication related to sustainability) and procedures. Publications must include key climate and environment-related metrics, and include relevant meaningful information.

The expectations on comprehensive risk management include risk management frameworks, scenario analyses, and stress scenarios. ECB expects climate change risks to be integrated into existing risk categories as they act as a driving force in all pre-existing risk types. Furthermore, banks should assess the relevance of climate and environmental risks and incorporate them into their scenario analyses. The expectation is that climate risks are assessed in the context of both a baseline and an adverse scenario.

The ECB has also set specific expectations for the management of different types of risk. When calculating **credit risk,** one should take into account climate and environmental aspects at all stages of the lending process and portfolios should be monitored accordingly. In the area of **operational risk,** the negative effects of climate change on business continuity and reputation should be taken into account. For **market risk,** climate and environmental factors should be monitored and scenarios capable of climate stress test should be established. For **liquidity risk,** climate and environmental factors should be incorporated into liquidity risk management and to the calibration of the liquidity capital buffer.

KPMG's survey

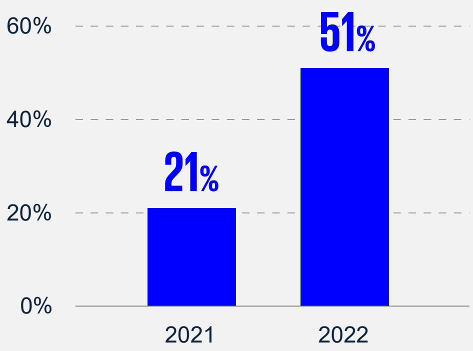
KPMG carried out a questionnaire survey to analyze the level of preparedness of banks, focusing on the ECB's 13 expectations. Overall, banks prioritize climate-related risks, while priority of other environmental risks (e.g. biodiversity loss), social risks and corporate governance risks are generally lower and vary widely across banks. A possible explanation is that the latter issues have more complex causal relationships than climate-related risks and may therefore be more challenging for banks to understand and incorporate into risk management.

Compared to 2021, the average level of preparedness of banks for the ECB's 13 expectations has increased from 21% to 51%. The biggest improvements were in the areas of scenario analysis and stress testing. Of the 33 large banks surveyed, 5 are already in compliance with the ECB expectations and a further 6 plans to be so in 2022. Full compliance is expected by 2025 by the EBC.

Based on banks' own assessment, institutions in Italy are the most compliant with ECB expectations. By comparison, banks in France rated their average compliance 10 percentage points lower.

ESG factors are mostly seen as a risk driver by banks, rather than as a separate risk type. More than half of banks have already quantified and incorporated ESG factors in some form. This is typically done through integration into current models or stress testing. The incorporation of ESG factors is most advanced in credit risk models.

Average level of preparedness



Source: KPMG AG Wirtschaftsprüfungsgesellschaft

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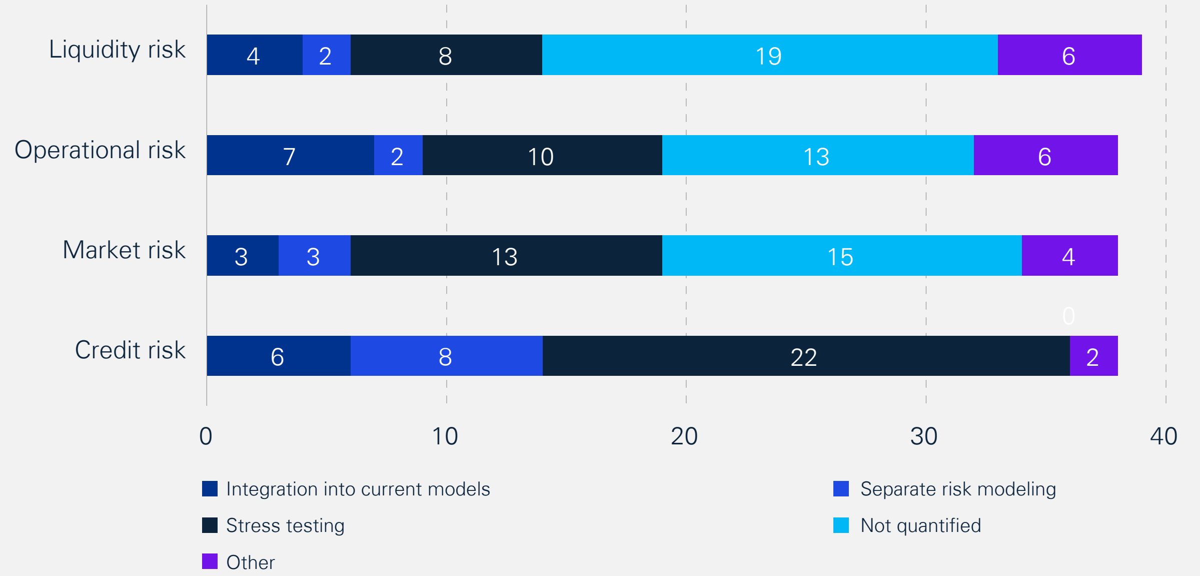
Frequency of separate risk types (more options)



Source: KPMG AG Wirtschaftsprüfungsgesellschaft

A challenge - Risks to biodiversity

One of the least known and most difficult to model is relating to biodiversity risks, the assessment of which the World Economic Forum has identified as one of the top five challenges for the next ten years. While other aspects of climate change, such as rising sea levels, are directly linked to a single driving factor, in this case GHG emissions, biodiversity loss is influenced by a number of different factors, including rising sea temperatures, loss of natural habitats, and even by a number of climate change mitigation investments, such as hydroelectric dams. Biodiversity loss is caused by change in land and water use, overconsumption, pollution, and the spread of invasive species. Consequences include transitional and physical risks, some good examples of the former are restrictive national and international regulations, shifts towards more sustainable solutions, and changes in consumer demand, whereas examples of the latter include droughts, floods, health risks and other systemic risks. It is not yet clear how European banks will assess the impact of biodiversity risks on the financial sector, although some actors have already worked hard to develop the first possible solutions. One such approach is the calculation of the biodiversity footprint, which can be used to identify particularly vulnerable or damaging sectors.

All things considered, most European banks are making increasing efforts to identify the environmental factors (E), but much less progress is being made on the social and governance factors (S and G, respectively). The response of the European legislators is to draw up a new Corporate Sustainability Reporting Directive (CSRD) to replace the NFRD and to prepare a Social Taxonomy, which would seek to include social and governance risks alongside environmental and climate risks with similar emphasis.

Geopolitical impacts and ESG

KPMG's analysis suggests that the ongoing military conflict in Europe is fundamentally changing assumptions about the global economy, which may shed new light and prompt banks to rethink their ESG strategies. The war has shaken confidence in four previously unquestioned principles: that the world's leading economies have an interest in ever-increasing prosperity; in promoting economic interconnectedness leading to interdependence and hence peaceful coexistence; in making the global labor market work primarily to increase efficiency; and in continuing to break down barriers to globalized goods and services. In the new world economic canon, however, interdependence is only desirable for countries with common broad geopolitical goals, with a much greater role for geostrategic interests in the allocation of labor alongside efficiency, and with increasing interference in the free flow of goods and services through subsidies, tariffs, sanctions, rules and other regulatory instruments.

However, the above change could act as a catalyst for a sustainable economic transition, in particular in the context of increasing renewable energy and energy efficiency, and the shift towards a circular economy. This assumption is confirmed by several examples: in Germany, discussions are underway to phase out fossil fuels by 2030 instead of 2038, and to rethink the phasing out of nuclear power by the end of 2022. Also, the European Raw Materials Association (ERMA) wants to reduce the EU's dependence on China for rare earths and other raw materials.

Based on the above, three main opportunities and risks can be identified for the banking sector:

- Value chains will shorten, which is good for sustainability, and cluster in nearby countries operating along the same values over the next few years, a process that will require substantial funding.
- With the shortening of value chains, we can expect a further push towards digitalization, which could also create a number of new needs for investment.
- Increasing energy efficiency and shifting towards renewable energy will require a significant inflow of funds, with the financial sector having an important role.

In terms of credit risks, shorter value chains and inefficiency in energy efficiency could lead to slowing growth and reduced profitability for many companies in various sectors, increasing the risk of default. This also shows that it makes sense to integrate sustainability risk analysis into the risk management framework as much as possible.

In the context of non-financial risks, cyber risks and compliance risks are expected to grow rapidly and substantially, with the potential for increasingly strong reputational factors, making it particularly important to pay attention to governance factors within ESG.

To sum up, geopolitical changes do not affect the need for ESG transformation in the medium to long term, and in fact, due to a number of factors, they reinforce the benefits of implementing ESG aspects in the foreseeable future.

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