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# ESG for banking : risk management

**ESG risks are material for banks and should be incorporated into risk management frameworks**

ESG affects financial institutions in their role as capital and risk intermediaries as well as investors. Inherent risks of climate transition should be managed to help maintain effective sustainable finance. Banks are increasingly concerned with their own ESG footprint on the environment, and the impact of changes in the environment on their business and risk profile. To date, banks have primarily focused on drivers of environmental risks, in particular transitional climate risks and physical climate risks. However, mature banks have progressed significantly with integrating ESG drivers into most elements of their risk management frameworks. This is increasingly becoming the standard.

## Embed ESG across risk management

ESG drivers potentially impact all elements of strategic and operational risk management, requiring changes and updates to risk strategy and key risk indicator/ key performance indicator (KRI/KPI) design, risk identification and quantification, credit scoring and decisioning, scenario analysis and stress testing, as well as risk aggregation and reporting. Moreover, all of these elements interact with other second and first line functions and processes, with many synergies to be leveraged — but also cross-functional interfaces to be managed.

Compounded by increasing regulatory pressure, banks should address all drivers of ESG risk. Research into European banks indicates that nine in 10 chief revenue officers (CROs) consider climate risks a top priority however; nature-related and biodiversity, social and governance risks are less mature.[1]

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[1] *ESG Risk Management in Banks,* KPMG in Germany, 2022.



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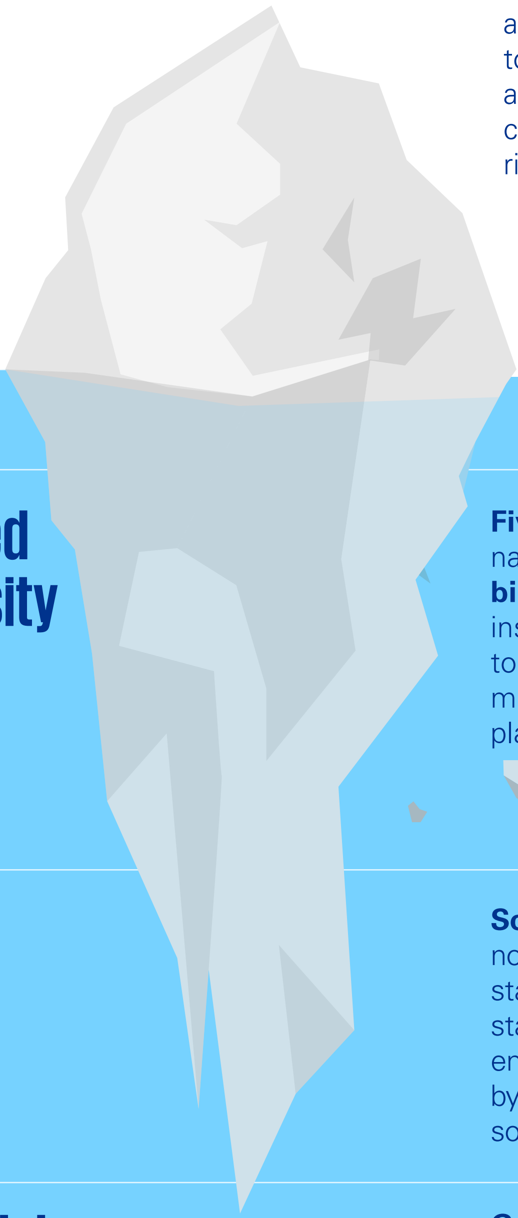
# The long journey: Addressing all drivers of ESG risk

**Research indicates that for most banks, 'ESG risk management' mostly means 'climate risk management' — with good reason, given the impact and urgency of global climate change.**

**Nine in 10 CROs** indicate that **climate risks** (both transition and physical risks) are their top-priority ESG risk drivers — and often the only ones currently considered in their risk management frameworks.



## Nature-related and biodiversity risks

**Five in 10 CROs** indicate that nature-related risks, especially **biodiversity risks,** are on their institutions' radar — with little to no risk identification or measurement methods in place.

## Social risks

**Social risks**, such as non-compliance with labor standards, lack of industrial safety standards or health protection for employees, are likewise prioritized by **five in 10 CROs** — albeit less so than climate risks.

## Governance risks

**Governance risks**, such as non-compliance with tax law, corruption or attempted bribery, are often included in banks' non-financial risk management frameworks, but **typically not as part of the overall risk management framework**.

Source: *ESG Risk Management in Banks*, KPMG in Germany, 2022.



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## Four key areas of investment for banks when considering ESG risks

### Scenario analysis and stress testing

Embed ESG drivers, particularly, climate risk, in the bank-wide stress testing program — i.e. implement sensitivity and scenario analysis frameworks that inform other aspects of risk management process.

**Market observation**

Most banks in mature markets have implemented prototype climate stress tests (typically transition risks first, followed by physical risks such as flood risk). Mature banks are now adding drivers like biodiversity risks or social risks.

### Credit scoring and decisioning

Design and implement methods to score borrowers' exposure to ESG risks and embed methods into credit policies, decisioning and monitoring processes.

**Market observation**

Qualitative or quantitative ESG risk scorecards (or 'client checklists') have become good practice, especially in Europe. Mature banks have started influencing credit decisions based on such scores — beyond simple exclusion criteria.

### KRI frameworks

Design and implement ESG-related key risk indicators as part of the risk appetite framework, aligned with business and risk strategy — and cascaded in a limit system at the entity and portfolio levels.

**Market observation**

Beyond first prototype methods and processes, mature banks are moving towards integrating ESG risks, with a focus on climate, in their risk strategies and appetites. Typical first KRIs include financed emissions, exposure limits to vulnerable sectors or geographies, or aggregated self-made ESG risk scores.

### ESG risk disclosure

Especially in Europe: Fulfil new and upcoming Pillar III requirements on disclosure of climate transition and physical risk — necessitating close collaboration between risk and finance organizations.

**Market observation**

European institutions are racing to build methodologies and reporting frameworks to comply with the European Banking Authority's (EBA) latest Pillar III requirements, often with particular focus on physical risks. Mature banks have prototype methods to assess physical risks in place and are producing dry-run reports by end of 2022.

KPMG firms can help your organization understand and integrate ESG into the risk management function.

Banks should develop and enhance their understanding and integration of ESG risks across all areas in an effort to successfully manage risk. **We can support you in the following areas:**

### Frameworks

Develop a taxonomy of ESG risk drivers and integrate them into existing risk management frameworks — including risk identification, risk appetite frameworks and ESG risk scorecards.

### Models

Support the design of prototypes and quantification methods for ESG risks, especially transition and physical climate risks, but also other E, S and G risks.

### Data

Support the design of ESG risk data frameworks and help choose the appropriate ESG data from public sources, commercial vendors and client-level questionnaires.

### Training

Leverage training assets to help familiarize and mobilize the risk function regarding challenges of ESG risk drivers and their implementation in the risk management framework.



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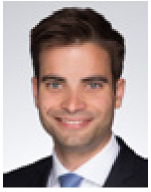
# Contact us


**Richard Bernau**
ESG Global Banking Lead
KPMG in the UK
**E:** richard.bernau@kpmg.co.uk



**Dr. Clemens Wieck**
EMA ESG Risk Banking Lead
KPMG in Germany
**E:** cwieck@kpmg.comcwieck@kpmg.com

**Noeleen Cowley**
EMA ESG Banking Co-Lead
KPMG in the UK
**E:** noeleen.cowley@kpmg.co.uk

**Christoph Betz**
EMA ESG Banking Co-Lead
KPMG in Germany
**E:** christophbetz@kpmg.com

**Steven Arnold**
Americas ESG Banking Lead
KPMG in the US
**E:** stevenarnold@kpmg.ie

**Gemini Yang**
ASPAC ESG Banking Lead
KPMG in Hong Kong
**E:** gemini.yang@kpmg.com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