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Banks and firms: initial findings on climate and environmental risk management

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Introduction

It is with great pleasure that I accepted the invitation to take part in the presentation of the book *L'impatto economico del cambiamento climatico* ('The economic impact of climate change'), edited by experts at Federcasse. The topic we have been discussing here today has for some time been, and increasingly is, a subject of public debate and one that has attracted the attention of central banks, supervisory authorities, industry and scholars.

Following an initial phase of recognition of the issue, we are now shifting into a new phase — one certainly more complex but no less stimulating — of progressive integration of 'climate-related factors' into the overall structure of the regulation and supervision of banks and non-bank intermediaries.

Analysis and research, such as that set out in the book, provide valuable insights for all the players involved, including supervisory authorities. That presented here today represents the industry's concrete contribution to 'raising the degree of information on and awareness of these issues', offering an indication of the level of understanding that SMEs and BCCs have about the economic impact of climate change.

Before sharing with you a few of my thoughts on the research described in the book, I would like to quickly touch on the regulatory debate occurring at international level. Afterwards I will provide a brief update on the main supervisory initiatives taking place at European level, within the SSM, and at national level. I will conclude by calling attention to the primary challenges currently facing the financial – and not just banking – system.

The debate on regulation

In recent months, the Basel Committee, the leading international banking regulator, has been considering how, and on what terms, to adapt the existing prudential framework for climate-related risks. In particular, a broad sequential approach has been

taken up until now, under which the most complex challenge is undoubtedly that of making possible adjustments to the capital requirements (the first pillar), owing in part to the lack of reliable and comprehensive data; a wish to avoid introducing into the framework new binding components, with the risk of possibly having to add more in the future; and the decision to not initiate any substantial changes to the Committee's framework after the finalization of Basel 3.

Conversely, the supervisory review process (the second pillar) is assuredly the most flexible and comprehensive tool for promoting the ecological transition. For example, the Principles for the effective management and supervision of climate-related financial risks,[1] published last June, offer a series of non-prescriptive guidelines intended to encourage sound risk management practices by supporting the necessary dialogue between banks and supervisory authorities. Finally, in terms of market disclosures (the third pillar), the work underway is focusing on developing specific standards, consistent with similar initiatives undertaken by other institutions.

At EU level, the work is at a more advanced stage: taking market disclosure requirements as a starting point, it has moved on to the supervisory process, leaving for a later time any assessments of whether and to what extent action should be taken on the calculation of capital requirements. More specifically, with regard to the 'second pillar', the European Commission's proposal for reviewing the prudential legislation (CRR3 and CRD6), published in October of last year, requires intermediaries to draw up multi-annual transition plans to monitor the risks arising from failure to respect the EU's climate targets.[2]

I would now like to say a few more words on the subject of disclosure: the availability of comprehensive and reliable data is not an end in and of itself, but is a crucial prerequisite on which to base analysis, dialogue with intermediaries, policy actions and supervision. Last January, the European Banking Authority (EBA) published implementing technical standards (ITS) for large banks listed on securities markets regarding the disclosure of information on the transition and physical risks related to climate change that may affect the exposures in their banking books starting January 2023.

The scope of application of the third pillar ESG requirements is also going to be extended: the current proposal to amend Article 449a of the CRR2 will require all banks, regardless of their size, to publish annually (half-yearly for large institutions listed on regulated markets) data and information on ESG risks based on the principle of proportionality.

At the same time, the new Corporate Sustainability Reporting Directive (CSRD), adopted by the European Parliament a few weeks ago,[3] seeks to innovate the current framework on non-financial reporting, providing for, among other things: (i) the inclusion within the scope of entities required to prepare sustainability reports all large companies

[1] https://www.bis.org/bcbs/publ/d532.pdf

[2] In addition, the EBA will have to report to the Commission in 2023 on whether to incorporate a special prudential treatment for exposures affected by environmental and social factors; a discussion paper (EBA/DP/2022/02) was recently published on this point to gather the banking industry's initial comments.

[3] The Council is scheduled to adopt the proposal on 28 November, after which it will be signed and published in the Official Journal of the EU. The directive will enter into force 20 days after its publication.

(even those not listed starting from 2025, while the CRSD will apply to those already within the scope of the NFRD starting from 2024) and, later on, listed SMEs too (from 2026), and (ii) the obligation to use the sustainability standards drafted by the EFRAG.[4]

The Bank of Italy has long been actively involved in the international forums that I have just mentioned, in which we share our thoughts, analyses and proposals. It is not easy at the moment to imagine what the outcome of these discussions might be, as some of them by their very nature require further analysis. Let us review our policies thus far: (i) any revisions of the current prudential framework must preserve its risk-based nature, in line with the concerns raised by the EBA about the possible introduction of adjustment factors, such as green supporting factors; (ii) the increased flexibility of the second pillar effectively facilitates the possible inclusion of climate-related factors in the supervisory evaluation process; and (iii) consistency between the various disclosure requirements must be ensured, along with a proportionate approach, especially for small banks.

The main findings reported in the book: some food for thought

Just flipping through the text of the volume presented today, I cannot help but agree with the analysis and ideas therein. First of all, I absolutely agree with the originality of the symmetrical approach taken in the analysis performed on the two parties in a credit relationship – banks and firms – bound together in an inseparable relationship of reciprocity and complementarity in the transition towards sustainable development. Delayed disclosure by firms is undoubtedly reflected in the difficulties that banks have in correctly quantifying the impact of climate-related risk; on the other side, the banks, with their expertise, could offer valuable support to their client firms.[5]

The work presented today is also a good example of the exploitation of public data, which serves to reinforce the need for system-wide accessibility and comparability. It contains interesting points to think about regarding firm demographics and the consequent destruction of value in the geographical areas stricken by natural disasters. It also describes SMEs' greater vulnerability to climate and environmental risks compared with larger companies due to their higher structural dependence on their local areas, both for procurement and for sales, which can put their own ability to survive at risk; greater financial constraints can also reduce the level of priority assigned to the investments needed for the transition.

It is therefore essential to raise the awareness of small and medium-sized enterprises about the significance of environmental phenomena for their business models and of 'creating a network' to provide support services and financial resources to enable them to identify common and sustainable paths to development. Local communities and the businesses themselves can benefit from this through easier access to bank credit.

[4] The European Financial Reporting Advisory Group (EFRAG) is a technical body that deals with international accounting standards. Along with the Accounting Regulatory Committee (ARC), which is political in nature, the EFRAG contributes to the approval process for accounting standards in Europe. The CSRD assigns to the EFRAG the new role of European sustainability standard setter.

[5] For more information, see also Siani, 'ESG factors in the financial system: the role of supervision', Ned Community – ESG risks in bank-company relations, 11 March 2022.

In this regard, the book stresses that cooperative credit banks can be the 'intermediate link' between the real economy and public bodies to provide support in drafting transition plans and to facilitate an efficient allocation of the public and private resources available for financing. Their role in accompanying 'their' local area in the transition will require community banks to make an initial push to review credit processes, in terms of integrating climate factors while granting loans and assessing creditworthiness, carefully monitoring counterparties' transition plans and properly evaluating pricing. Small businesses will also have to be proactive, have the ability to collaborate and be willing to be more transparent. Where such preconditions are met, the firm-bank relationship will be strengthened by creating value for both parties.

The low level of awareness displayed by the SMEs can be partly mitigated by greater attention on the part the BCCs sampled to the impact of climate risk on their business and that of their customers. The analysis highlights a growing awareness of the impact of climate-related factors on the operations of BCCs, given that all the intermediaries interviewed have developed business continuity plans to tackle risks and identify solutions that can effectively address critical situations, but also a widespread inability to quantify their impact on the credit policies adopted and the related financial risks.[6]

The cooperative banking sector, and more generally the banking system along with the scientific community, must continue to study these phenomena, increasing the number of entities surveyed, expanding the range of risk factors considered (for example, physical risks, drought, heat waves, rising sea levels) and supporting methodologies based on historical time series with scenario analysis and stress tests over ten-year time horizons.

In particular, in order to improve their ability to measure the impact of climate and environmental risk factors, the exercises described in the book should be increasingly directed towards refining the methods of analysis and the metrics for measurement, for example by adding further detail to the qualitative questionnaires submitted to counterparties and by developing more granular and forward-looking performance and risk indicators.

Supervisory action

The supervisory authorities have launched initiatives to encourage the banking and financial system to revise their management paradigms. The ECB and some national authorities, including the Bank of Italy, have published their initial 'supervisory expectations' regarding the integration of climate and environmental risks into corporate strategy and organization, into governance and the internal control system, and into risk management and market disclosure. To verify the degree of integration of climate risks in the practices of banking and financial intermediaries, thematic reviews were conducted to assess the adequacy of the initiatives undertaken by intermediaries within the framework of the supervisory dialogue.

[6] According to the analysis carried out, not only does the company birth rate not appear to be affected by hydrogeological risk, but there are also no clear signs of a significant effect on the disbursement of bank loans beyond the short term over the 2013-2018 period.

After the publication of the Guide on Climate-Related and Environmental Risks in 2021, the ECB initially requested a self-assessment exercise to assess the degree of preparedness of significant institutions (SI) and the adequacy of their implementation plans. In addition, the thematic review carried out in the first half of 2022 offered further insights into the strategies, governance and climate and environmental risk management processes. This was an unprecedented initiative involving 186 banks — of which about 80 less significant institutions (LSI)[7] — as well as 8 national supervisory authorities, including the Bank of Italy.

The thematic review also revealed that most of the significant banks recognize the centrality of climate risks, believe that they are significantly exposed to them over the current planning horizon and have introduced, at a minimum, elementary procedures for meeting at least half of the ECB's expectations.

However, the review uncovered gaps in integrating them into business strategies, decision-making processes, the roles and responsibilities of the various organizational levels, and internal control processes. Furthermore, the methodologies adopted for climate risk management and monitoring are still very simple, in part due to the lack of sufficiently granular and forward-looking data.[8]

In addition, almost all the banks (96 per cent) show blind spots in identifying a comprehensive set of risk drivers and in defining the appropriate time horizons and geographical areas. Moreover, the exercise also recognized the existence of good practices, which for the first time the ECB has published in a compendium in order to highlight existing excellence and share state-of-the-art solutions.

Referring to just the twelve Italian intermediaries involved, four had already put into place internal procedures that are advanced in terms of the quality and completeness of the solutions adopted, thereby also contributing to the compendium of good practices. As a general rule, the results of the Italian significant banks are consistent with the overall dynamics of the SSM banks: almost all have implemented internal measures for managing climate and environmental risks, without however covering all areas where these risks are significant. Similarly, the quality of the methodologies adopted is still limited, while the most significant shortcomings are observed in the materiality assessment of the risks, in risk management, as well as in the incorporation of climate-related factors into internal procedures for monitoring specific risks.

In line with the analysis of questionnaires administered to a sample of small and medium-sized enterprises (SMEs) and cooperative credit banks (BCCs), which are reported in the book, the latter type of intermediaries as a whole appear to be affected by lags in the economic environment in which they operate and the resulting greater lack of data and information. In fact, despite their decision-making bodies' increased awareness of climate and environmental risks and their strategies being progressively more informed by such risks, BCCs appear to be significantly behind the larger banks in terms of developing appropriate methodologies to quantify the impact and relevance of

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[7] The Bank of Italy participated with a sample of 21 LSIs; the authorities of the following countries also took part: Austria (with 4 LSIs), France (6), Germany (16), Malta (4), the Netherlands (22), Portugal (2) and Spain (4).
[8] For example, there are no detailed KPIs (at the individual portfolio level) with well-calibrated thresholds and limits, clear mitigation actions and escalation arrangements in the event of breaches.

these risk factors.

Moreover, the consolidation of the cooperative credit sector into groups, which has begun in recent years, will likely enable BCCs to face the challenge of the green transition from a stronger position compared with the situation before the consolidation. Indeed, while continuing to rely on the geographical proximity to their customers that is their hallmark, being part of a group can make it easier for BCCs to harness greater economies of scale in order to curb the high initial costs necessary for the revision of strategies, for the introduction of suitable arrangements to identify, measure, monitor and mitigate these risks and develop new methodologies, and for the collection of more granular data. Moreover, the limited resilience of individual BCCs to physical risks – especially extreme climate events that are structurally localized – can be effectively counterbalanced by the resilience developed at group level, as it is associated with greater geographical diversification.

Last April, the Bank of Italy published an initial document setting out its 'supervisory expectations' regarding supervised intermediaries, both banking and financial.[9] In addition, in the second quarter of 2022, it carried out its first structured survey on the level of integration of climate and environmental risks into the management systems of less significant institutions (LSIs), thereby taking part, as already mentioned, in the ECB's thematic review discussed earlier, with a sample of 21 intermediaries. The findings on LSIs will be published soon[10] and will also include a section dedicated to the 'good practices' that emerged from the survey, with a view to promoting their progressive alignment with supervisory expectations.

In general, apart from some positive exceptions, the exercise pointed to a low degree of alignment with expectations but, at the same time, a widespread and growing awareness of the importance of the issue for the sustainability of the business models going forward. For example, climate and environmental issues are now on the agendas of almost all the boards of directors of the banks included in the sample; many LSIs have undertaken structured training initiatives for their boards of directors and some have included expertise on climate and environmental issues in the criteria to be used to assess the collective adequacy of their board members. However, there is still a widespread knowledge gap in terms of governance, which is especially large for some banks that have proved to be not as well prepared on the different profiles examined.

The growing attention to environmental issues has also been reflected in the development, by various intermediaries, of a mapping of the regulatory and/or competitive framework, in order to identify the measures needed to adapt processes, policies and strategies to ensure the sustainability of their operating model.

Conversely, the difficulty in obtaining robust and reliable data is the main point that deserves attention in all the areas of investigation. In this regard, only a limited number of banks have launched comprehensive data collection and management projects, including through external suppliers, to support the development of metrics for the assessment of climate and environmental factors. It follows that materiality assessments

[9] Banca d'Italia, 'Aspettative di vigilanza sui rischi climatici e ambientali' (only in Italian).

[10] The survey focused on the following areas: governance and risk appetite, materiality assessment, business model and strategy, and risk management.

are conducted essentially on a qualitative basis and/or are limited only to certain physical or transition risk factors.

The data gaps are reflected in particular in risk management, the area in which the most significant shortcomings are observed, and they inhibit the establishment of an adequate governance system that combines the incorporation of data into the business operating processes with the necessary assessment of the units responsible for these processes and, therefore, of a structured framework for the correct identification, monitoring and management of climate-related risks. In fact, only a very small number of LSIs have developed a quantitative approach that can be used to lay out objectives in terms of risk appetite; furthermore, stress tests, which are a prerequisite for internal capital adequacy assessments, hardly ever include climate and environmental factors.

With specific reference to credit risk, some banks have started, or have planned, to integrate climate and environmental factors into the credit granting and monitoring processes; to this end, they have developed targeted questionnaires as the main tool to collect the data to be used to assign ESG risk scores, which are in some cases based on proprietary methodologies that are both qualitative and quantitative but in most cases are calculated using applications developed by external providers.

The aforementioned difficulties in obtaining and managing data inevitably also affect other areas considered in the survey: reporting on the governance and control functions seldom contains information on the exposure to climate and environmental risk factors; rarely do strategic plans include 'green' performance targets; climate risks are not given sufficient consideration in the design of remuneration policies and of the internal control system.

In this context, the majority of the LSIs included in the sample indicated that they had initiated or planned some initiatives — also by teaming up with other banks — to promote a progressive alignment with expectations; however, almost no intermediary has yet set out these measures in a structured plan (i.e. with the starting dates of specific tasks together with the people in charge and the timeframe involved), approved by the board of directors. It should also be noted that the publication of the supervisory expectations and the launch of the aforementioned assessment exercise have increased the system's level of awareness, thereby accelerating the creation and implementation of the projects.

At the conclusion of this first survey, the Bank of Italy will publish a list of the good practices found so far and will require the management bodies of all the LSIs involved to approve an 'appropriate plan of initiatives' aimed at charting, for the next three years, a course of progressive alignment with expectations, setting out the time required to adapt the main corporate policies and the organizational and management systems in a coherent way.[11] These action plans will act as a benchmark for future supervisory dialogue with the LSIs.

The challenges of today and of the coming years

[11] The adoption of a plan of initiatives is explicitly laid out in Expectation No. 1 of the Bank of Italy.

The two thematic reviews conducted both suggest that the supervisory activity carried out during the last two years is helping to activate a virtuous circle for the green transition, despite the complexity of the ongoing process.

On the other hand, it is clear that much remains to be done to fully exploit the business opportunities that could come out of the ecological transition, for example the growth of high-quality jobs and the expansion of the range of services offered to customers. All the players involved must therefore incur a significant initial cost to equip themselves with the appropriate tools for identifying, measuring, monitoring and mitigating the economic impact of climate and environmental factors.

In this respect, the Bank of Italy has in recent months launched a technical dialogue with the Italian financial industry in order to monitor and assess the degree of preparation of the system for the forthcoming regulatory requirements on ESG reporting. However, at the current stage, the main problem that firms and the banking sector are facing is still the lack of sustainability data, which explains much of the delay intermediaries are displaying in aligning with supervisory expectations and represents one of the main obstacles to the allocation of financial resources in favour of the environmental transition'.[12]

For the banking sector, the systematic and orderly collection of ESG data and information must not be aimed exclusively at complying with the aforementioned disclosure obligations defined at international level which are, moreover, closely connected to those of the companies to which they lend. Rather, it must be integrated into an adequate data governance approach, in which disclosing information to the market is, in reality, only the last phase of a long and multifaceted process, at the end of which the information — which is necessary for the day-to-day operation of the intermediary and therefore already fully used for management purposes — is finally shared with the stakeholders.

On the one hand, comprehensive disclosure to the market, through the correct representation of their exposure to ESG risk factors and their contribution to the ecological transition, will increase the credibility of banking intermediaries' transition plans — in line with the ongoing supervisory analysis — and will enable market participants to assign more accurate ESG scores to the banking intermediaries themselves, something that will potentially be reflected in the assessments of their creditworthiness and, ultimately, in the cost of their securities funding. This will be even more important for those BCCs that will — through their parent company — be immediately subject to the new ESG disclosure obligations.

On the other hand, increased availability of data is indispensable to banks both for the credit process and to better manage the climate and environmental risks of their portfolio. In particular, adequate quantification of climate and environmental risks is necessary to support lending policies, especially for assessing the creditworthiness of the

[12] Paolo Angelini (2022), 'I rischi finanziari posti dai cambiamenti climatici: carenze informative e piani di transizione', Associazione nazionale per lo studio dei problemi del credito (National Association for the Study of Credit Problems), 15 November 2022.

counterparty and for calculating an adequate risk-adjusted return. Furthermore, the collection of sufficiently granular, comparable and verifiable data for individual counterparties, sectors and geographical areas serves to enable a correct identification of the impact of climate and environmental risk factors on all traditional financial risks: credit, market and operational.

The lack of such data could, for example, prevent the timely detection of climate and environmental risk concentration, not only for an individual counterpart, but for certain sectors or geographical areas. In addition, the availability of such information may also make it possible to account for the economic effects associated with these risks, paying particular attention to the impact on the classification and measurement of financial instruments under IFRS 9.

Another consideration concerns ESG information from outsourcers. These data are useful and often provide an indispensable starting point for integrating environmental risks into climate risk management and governance. However, they must be assessed and verified by banks ever more thoroughly in order to understand their limitations and how they might actually be used.

In this sense, it is important that the financial sector pursues a dual business objective; first, it is necessary to strengthen governance and control systems for externally acquired ESG data, also by better grasping and mastering the methodologies used for collecting and estimating such data. In fact, it is essential that intermediaries define appropriate guidelines aimed at gaining sufficient awareness of the characteristics and quality of the data used, for example in terms of internal responsibilities, analysis of the methods used to construct the data and of the proxies used, sample verification, and possible benchmarking analyses.

Moreover, it is essential to integrate — also through shared solutions among trade associations — the data obtained from external suppliers with those collected directly from customers and, where present, also from the latter's non-financial disclosure information. In the first years of application of the new disclosure standards a higher level of granularity will likely be available only for larger companies, while for smaller ones, the use of average sectoral data will also be necessary. In particular, with regard to SMEs, appropriate non-financial reporting requirements and standards will have to be defined based on the principle of proportionality.

Finally, it should be pointed out that an approach to the issue of data availability that imposes burdens exclusively on the financial system while almost completely ignoring non-financial corporations runs the risk of being ineffective. It is therefore essential to establish a continuous dialogue between the banking industry and the trade associations representing non-financial corporations in order to identify the difficulties faced by the latter in providing ESG information and to develop a collaborative approach aimed at closing the current information gaps. The Bank of Italy's commitment in this field is steadfast and is only growing.

It will therefore be crucial to raise awareness among small and medium-sized enterprises of the importance of non-financial disclosure as a tool to increase firms' cognizance of ESG risks and, consequently, their resilience to climate change, but also to

facilitate the systematic collection of detailed information on the opportunities and revenues that ESG factors can generate for firms.

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The green and sustainable transition is creating new business opportunities in terms of growth in high quality jobs and the expansion of the range of services provided to customers. However, it requires a significant effort from all the players involved. The ongoing regulatory process and supervisory action have led to the launch of projects aimed at raising the awareness of the banking and financial system and at revising management systems.

The book presented today underscores the following: the value added that can be derived from the knowledge of and proximity to the geographical area in which the players operate in terms of ESG risk assessment and management; the significant efforts that are still to be made to quantify physical risk; and the importance of the joint contribution of firms and the banking system to promote the appropriate representation of exposure to climate risk.

Coordinated initiatives at national level, together with those at grassroots level, can certainly help to provide adequate support to the system as a whole in this long and multifaceted transition process. The BCCs can play a valuable role thanks to their proximity to the area in which they operate, particularly owing to their position as preferred business partners of SMEs.

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