Asset management: early evidence on climate-related and environmental risks

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Sustainability issues, also known as Environmental, Social and Governance (ESG) issues, have long been central to the European and international political agenda, the work of the supervisory authorities and the day-to-day activities of financial operators. The initiatives of the supervisory authorities cover all the various ESG areas, but it is on environmental risks, and especially climate-related risks, that their work focuses most intensely.

The significant increases in energy prices, the ongoing geopolitical tensions, the high inflation environment and the resulting shift away from the accommodative monetary policies that held sway for more than a decade pose new challenges to the ambitious sustainability paths being pursued. Reversing the trends of past years, investments in 'sustainable' sectors yielded lower returns over the course of 2022 compared with the sectors linked to energy production, processing and distribution and with the defence industry.

However, these developments will have to be assessed over a longer time horizon and should not slow down the transition towards sustainable business models, in particular with regard to the decarbonization of our economic systems; the vulnerabilities of Europe's energy supply model make the transition to renewable sources cost-effective and even more urgent.

1. The role of non-bank intermediaries

For more than a decade now, the share of non-bank financial intermediaries out of the total financing of the economy has been on an upward trend worldwide. In Italy, the banking system has historically played a dominant role and the share of non-bank finance has remained fairly stable over time. However, there has been a considerable increase in the role of non-bank intermediaries, in particular asset managers.

Moreover, in recent years, a growing share of the asset management industry has embraced sustainability criteria: the increase in sustainable investments or in products with characteristics that promote sustainability (Articles 9 and 8, respectively, of the EU Sustainable Finance Disclosure Regulation, or SFDR) continued notwithstanding a market environment in which funds recorded, on average, negative returns and net outflows.[1]

The same trend has been observed in Italy, though on a smaller scale: at the end of the third quarter of 2022, 'sustainable' products accounted for 40 per cent of the total, which, although lower than the European average, still increased compared with the 34.7 per cent registered at end-2021.[2]

The sustainability challenge, therefore, not only concerns banks, but also has direct implications for those financial intermediaries that play a significant role in mobilizing and channelling the financial resources needed to fund the investments intended to support the ecological and energy transition.

Furthermore, non-bank intermediaries hold equity stakes and thus have the potential to directly influence firms' strategic choices. They can also play an advisory role on sustainability issues for businesses, in particular those least equipped to carry out an independent analysis.

2. The latest regulatory developments

The development of sustainable finance has also been influenced by major changes in European regulations, which predated and partly drove advances in financial intermediation, in particular with regard to product structuring and disclosure.

In recent months, the finalization and entry into force of a number of measures have made it possible to continue on the path of further completing the regulatory framework. I am referring, for example, to the full entry into force of the SFDR on 1 January 2023, which encourages market disclosure on the part of financial service providers and investment advisory entities by setting harmonized rules intended to improve data quality and the comparability of products in terms of sustainability.

In addition, effective on the same date, non-financial corporations subject to disclosure requirements under Article 8 of the Taxonomy Regulation must start providing data on key performance indicators (KPIs) relating to the share of their activities that comply with the taxonomy.[3]

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1 The SFDR identifies three categories of investment products with different disclosure obligations. They are conventionally labelled based on the corresponding reference article: sustainable investments under Article 9, in which all the fund's assets are devoted to pursuing a given sustainable investment objective; investments that promote sustainability characteristics pursuant to Article 8, in which sustainability factors play an important role in investment choices while no specific sustainability objectives are pursued; and the residual category of non-sustainable investments referenced in Article 6.

2 Source: Assogestioni data.

3 Starting next year, financial corporations are required comply with this obligation, which will also entail the calculation of indicators such as the Green Asset Ratio and the Green Investment Ratio.

On 5 January, the new Corporate Sustainability Reporting Directive (CSRD) also came into force and, together with the associated EFRAG sustainability standards, will apply to both financial and large non-financial corporations, as well as to listed companies.

Finally, a further important piece of the European legislative framework is the proposal for a Corporate Sustainability Due Diligence Directive (CSDDD), which would require large (financial and non-financial) corporations to identify, prevent and mitigate the adverse impacts of business on human rights and the environment, as well as to prepare a transition plan consistent with the Paris Agreement.

In particular, intermediaries should either refrain from investing in counterparties whose business activity has a negative impact on the environment and human rights, or should draw up measures, which could potentially be very costly, to mitigate and reduce this impact. The Directive would have particularly significant implications for the entire 'value chain' of large businesses, including suppliers and customers, regardless of their size.

This regulatory framework provides for stringent and incisive rules that place the European Union at the forefront of the global fight against climate change. However, the application of these rules in practice has uncovered some areas of concern and some need for refinement.

I am referring, for example, to:

a) the considerable complexity of the taxonomy and disclosure framework, which places non-trivial compliance burdens on intermediaries, especially smaller ones. The lengthy phase-in process of these rules which, while facilitating the gradual adaptation of business practices to the new standards, risks creating uncertainties and inconsistencies in the time sequence of the various measures;

b) the existing significant ESG data gaps, especially with regard to small and medium-sized enterprises (SMEs), which risk putting these businesses at a serious disadvantage and which will not be fully addressed by the implementation of the Corporate Sustainability Reporting Directive (CSRD); and

c) interpretative doubts regarding the implementation of the taxonomy and of the SFDR framework, which risk having unintended pro-cyclical effects, making it more difficult to access financial resources for those companies that most need them to fund the start of their transition plans.

Further adjustments are therefore needed to make the rules more effective and overcome the most critical aspects, also to avoid repercussions on the competitiveness of EU firms in comparison with non-EU companies located in areas of the planet where sustainability is not addressed with the same sensitivity.

The Bank of Italy's efforts will continue in the various national and international forums, with the aim of ensuring convergence towards internationally recognized standards and eliminating any areas of uncertainty, thereby reducing compliance costs. The principle of proportionality should also be safeguarded, for example by assessing the materiality of these risks for the specific activities considered, especially for smaller intermediaries, and by closing the ESG data gap.

3. The Bank of Italy's supervisory activity

The growing focus on environmental issues has created major business opportunities and has highlighted the relevance of climate-related risks and the need for all intermediaries to assess and manage them correctly with a view to ensuring sound and prudent management. For this reason, similar to other initiatives launched under the Single Supervisory Mechanism (SSM), in April 2022 the Bank of Italy published its first 'Supervisory expectations for climate-related and environmental risks' (the 'Supervisory Expectations'),[4] containing non-binding recommendations for supervised banking and financial intermediaries on the integration of climate-related and environmental risks (both physical and transition risks) into their business models and corporate strategies, organizational systems and business processes, risk management systems, and market disclosure policies.

The publication of the Supervisory Expectations was a first step towards raising awareness in the financial system about the relevance of these risks in the business strategies and management of intermediaries, outlining a medium-term path for a gradual alignment of business practices with their principles.

Following a step-by-step approach, the Supervisory Expectations will be amended as necessary to keep pace with the development of best practices, the changing regulatory framework, and new evidence gained during the supervisory dialogue within the Supervisory Review and Evaluation Process (SREP), as well as with exchanges of views with the industry such as today's workshop.

A key feature of this document is that it adopts the same approach for all types of intermediaries supervised by the Bank of Italy, which ensures the consistency of the supervisory action and the application of the same principles to the same activity regardless of the legal form under which it is carried out. Exposure to traditional and climate-related risks depends on the intermediary's actual business model rather than on the institutional category into which it falls.

Consider, for example, asset management companies managing credit funds, which – as is the case for banks and many financial intermediaries under Article 106 of the Consolidated Law on Banking – are required to assess climate-related and environmental risks, in the form of both physical and transition risks, as part of the lending process. Similarly, banks that are particularly active in the asset management sector and insurance companies that market solutions akin to investment products are exposed to ESG risk profiles similar to those of the asset management sector.

Rather, a key difference is whether an intermediary invests and takes on risks on its own account or whether it manages (or advises on) the financial resources of third parties. In the former case, the determination of the level of exposure to climate-related and environmental risks that is considered acceptable must be incorporated into the

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[4] https://www.bancaditalia.it/focus/finanza-sostenibile/vigilanza-bancaria/Aspettative_di_vigilanza_BI_su_ESG.pdf

intermediary's Risk Appetite Framework (RAF) and reflects the risk appetite deemed adequate by the senior management in relation to its economic and capital situation. In the latter case, instead, the level of exposure to climate-related and environmental risks is inevitably influenced by investors' choices, while intermediaries must correctly measure, manage and report the ESG risks and adopt a strategy that clearly lays out the sustainability requirements for investments to be proposed to the market and to investors.

Intermediaries – even those belonging to the same legal category – may differ significantly in the business model adopted, in size, and in the complexity of their investment strategies. For the asset management sector, the actual breakdown of ESG factors depends on the type of funds managed and the type of investors involved. It is therefore necessary to apply the principle of proportionality correctly when assessing the situation of each intermediary on the basis of the business model it adopted, its size and its operational complexity.

Following the publication of the Supervisory Expectations, the Bank of Italy distributed a self-assessment questionnaire to a sample of 86 non-bank intermediaries – including 40 asset management companies (SGRs) – to determine to what extent climate-related and environmental risks have been integrated into their organizational systems, especially regarding the following areas: (i) business model and strategy; (ii) governance and organization; (iii) risk management system; (iv) market disclosure.

This questionnaire allowed the Bank of Italy to carry out an initial assessment of non-bank intermediaries' level of alignment with the Supervisory Expectations. The responses showed limited alignment with the Supervisory Expectations: while top management is generally aware of ESG issues, widespread shortcomings were found, with delays in the implementation and often also in the planning of structural changes within their organization.

The main findings show that:

a) in terms of <u>business model and strategy adopted</u>, the majority of intermediaries addressed the sustainability of their business model only in terms of adding 'green' or 'socially responsible' products to their offering, while little attention was paid to the achievement of measurable sustainability goals and the definition of specific performance indicators;

b) in terms of <u>governance</u> and organizational systems, the main weaknesses identified were a low level of expertise on climate-related and environmental issues in the governing bodies, an insufficient reporting system, and an unclear definition of roles and responsibilities within the boards;

c) in terms of <u>risk management</u> systems, the oversight action by the control functions was found to be lacking. Furthermore, a very common problem is the limited availability of data that can be used to measure risks; specifically, the quality of the data, which were gathered mainly by external providers, has not been assessed adequately, given the weak data governance strategies and an insufficient integration of these data into corporate information systems.

A joint effort on data is needed on the part of intermediaries and non-financial companies. Data providers can play a role, but at present they tend to rely on estimates that are often not particularly reliable for individual firms.

Despite the weaknesses described above, an analysis of the questionnaires showed many preliminary good practices, reflecting the variety of approaches adopted by non-banks.

For example, we have found that:

a) as for the business model and associated strategic risk, some intermediaries have performed an analysis of the business environment and a materiality assessment of climate-related risks as a key prerequisite for determining their sustainability strategies. Another good practice that has arisen is the definition of specific KPIs for monitoring the achievement of ESG goals chosen during strategic planning;

b) with regard to governance and control systems, some intermediaries have drawn up a specific sustainability policy setting out the corresponding responsibilities, either by directly assigning powers to the board of directors or by creating dedicated organizational structures. Other companies have developed training programmes for employees and managers and have included measurable, not merely formal, sustainability goals in their remuneration policies;

c) in the context of risk management, some intermediaries have begun or have planned an initial mapping of the effects of climate-related and environmental risks on their business in order to assess the impact on their organization. The results of these analyses will serve as the basis for the inclusion of sustainability risks in the RAF and in internal capital adequacy assessment processes.

The assessments of the results and of the measures just mentioned should be viewed in light of the principle of proportionality; for example, the Supervisory Expectations certainly require greater effort on the part of large intermediaries than of smaller ones even with the same exposure to climate-related and environmental risks.

This is true, for example, of those intermediaries that, following the principle of proportionality, have established a single control function and that plan to take action consistent with the degree of complexity of their business. Similarly, an asset management company (SGR) that manages a large number of funds will need a more structured system for reporting on ESG risks to senior management, as well as measures to make governance systems more rigorous, compared with a ‘below-the-threshold’ SGR that manages a small number of funds.

The principle of proportionality also applies to the assessment of data governance policies, as it may be sufficient for a smaller intermediary to rely on data from external providers, albeit with the appropriate evaluations and adjustments, while larger intermediaries would have to also input internal data or indicators into their databases.

4. Action plans and future supervisory activities

An examination of the preliminary results described and the dialogue initiated in recent months with industry representatives has revealed the need to ask all intermediaries to draw up an Action Plan (Plan) that includes:

a) an internal assessment of the degree to which business practices align with the Supervisory Expectations;[5]

b) an assessment of the materiality of exposure to climate-related and environmental risks on the basis of the specific business model adopted and the intermediary's size and organizational complexity;

c) an indication of specific measures to be taken to address any identified gaps;

d) the definition of the priorities and time frame needed to complete the actions, taking into account the level of exposure to the risks and the size and complexity of the intermediary's operations;

Plans must be approved by the boards of directors and submitted to the Bank of Italy, along with the assessment of the boards of auditors, by the end of March 2023.

Plans will then be evaluated as part of the annual Supervisory Review and Evaluation Process (SREP) carried out by the Bank of Italy for all supervised intermediaries. However, the preparation of the Plans is only the first step in the process of aligning practices with supervisory expectations in the context of our supervisory dialogue, a process that will involve intermediaries and the Bank of Italy working side by side for years to come.

We therefore expect there to be improvements and refinements in the degree of alignment with the Supervisory Expectations over the coming months, in accordance with the principle of proportionality and a gradual and targeted supervisory approach with the goal of reaching a satisfactory level of alignment over the medium term.

The Bank of Italy is aware this will require a great deal of effort, especially on the part of smaller intermediaries that were not asked to respond to the self-assessment questionnaire.

We are nonetheless committed to ensuring our support, for example by providing clarification on the Supervisory Expectations and the process as needed and by frequently communicating with intermediaries and trade associations. For this reason, we have prepared a template, available upon request, which can be used to help draw up the Action Plans. Furthermore, we will make available to the trade associations a document that summarizes the good practices referred to earlier, which intermediaries may also use in preparing their Plans.

The Bank of Italy will apply the necessary flexibility and proportionality in evaluating the Plans. However, we expect intermediaries to make every effort to meet the March deadline, in particular those that have already completed the self-assessment questionnaire.

These efforts must consist of concrete actions, with measurable targets and specific deadlines, possibly broken down into intermediate steps, over a medium-term horizon of approximately three years.

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5 To do this, intermediaries can use, for internal purposes, the questionnaire employed by the Bank of Italy for the April 2022 survey and which is available upon request.

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We are passing through a particularly complex transition period, in which, beyond the effects of the crisis mentioned before, we face a series of difficulties tied to the complexity of the issues involved, the uncertainty as to how the rules are to be interpreted and applied, and the problems encountered in translating general principles into concrete actions.

Non-bank intermediaries play a key role in the transition process. However, this process poses a number of new risks and, from a prudential supervision standpoint, it is equally important that intermediaries are able to properly assess and manage these risks, in accordance with their specific role in the financial system.

Intermediaries that, like banks, invest by assuming risks on their own account, must ensure sound and prudent management by monitoring the environmental risks that affect their capital and financial position; intermediaries must soundly and prudently manage third-party assets by pursuing adequate risk management of portfolios, engaging in fair conduct and making transparent disclosure to their customers.

In line with the framework set out in the Supervisory Expectations, intermediaries are required to adopt a pragmatic and gradual approach to increasingly align their practices with the Supervisory Expectations.

This workshop underscores the importance of dialogue between the Bank of Italy and market participants to clarify any doubts and to promote the creation of concrete and targeted action plans.