BANCA D'ITALIA
EUROSISTEMA

Climate and environmental risks. Main findings of a Bank of Italy survey on a sample of less significant institutions.

1. Introduction

In April 2022, the Bank of Italy issued its first 'Supervisory expectations for climate and environmental risks' (the 'Expectations'), containing non-binding indications for supervised banking and financial intermediaries on the integration of climate-related and environmental risks into their **governance and control systems**, **business models and strategies**, **organizational systems and business processes**, **risk management systems** and **market disclosure**.[1]

To this end, intermediaries were urged to examine and assess the relevance of climate-related and environmental issues to their own operations[2] and to design solutions that match their actual level of risk exposure based on the type, scale and complexity of their activities.

In the second quarter of 2022, the Bank of Italy conducted its first survey on the extent of integration of climate and environmental risks into the organizational system of Less Significant Institutions (LSIs) and took part in the ECB survey on Significant Institutions (SIs), with/using a sample of 21 intermediaries. Specifically, the survey focused on the following areas: governance and risk tolerance, materiality assessment, business models and strategies, and risk management.

Apart from a few positive exceptions, the study, which covered both transition and physical risk, showed that the Expectations **have barely been met** but, at the same time, it revealed a **widespread and growing awareness** of the key role of this issue in the future sustainability of business models.

This letter aims to illustrate the main focus points and 'good practices' that emerged from the survey and it confirms that the Bank of Italy anticipates that the system will gradually be brought in line with the expectations. Further details are available in the report published on the Bank of Italy's website. More specifically, the Bank of Italy expects **all LSIs to draw up action plans** designed to fully incorporate climate risks into their ordinary risk management and governance frameworks over the next three years.

2. Main findings

Climate and environmental risk management is now in the purview of many **boards of directors**, which have amended their rules of procedure and sought suitable organizational solutions for monitoring the issue (e.g. by establishing ad hoc internal committees or, in the most advanced entities, assigning the coordination of action plans to dedicated structures).

Many banks have launched structured training programmes catering to board members, in some cases including climate and environmental knowledge among the criteria for assessing the collective suitability of the BoD. Nonetheless, there is still a widespread knowledge gap on the boards, especially evident in some banks that have proven to be less prepared with regard to the various matters examined.

The increasing attention paid to environmental issues is also reflected in the analyses

[1] https://www.bancaditalia.it/media/notizia/aspettative-di-vigilanza-sui-rischi-climatici-e-ambientali/

[2] Although the expectations focus on environmental issues, the intermediaries can also apply them to the broader category of ESG risks if they are relevant for their operations and provided that they comply with industry-specific legislation.

conducted by several intermediaries in order to map the relevant regulatory framework and/or the competitive environment, in order to identify the actions needed to adapt the processes, policies, and strategies to be implemented in the short and medium term and to ensure the future **sustainability of their business model**.

As expected, the biggest problem is the availability of **data and IT systems** capable of properly managing those data. As a consequence: the use of quantitative approaches in climate risk measurement is still rare and not really integrated; risk management processes are rather unstructured; Key Risk Indicators (KRIs) and Key Performance Indicators (KPIs) are not commonly used to express objectives.

In particular, the study found delays in the design of structured processes for assessing the **materiality of climate-related risks**: most banks in the sample had only conducted a qualitative assessment of the potential impact of environmental factors on the most significant risks for their business models, while a residual share of banks did not carry out any assessment at all.

The areas of focus relevant in the materiality assessment create delays in the inclusion of climate risks in the **risk management** framework. In fact, although LSIs have started to consider climate-related factors among the possible drivers leading to the emergence of risks linked to traditional activities (e.g. credit and operational risk), only a limited number of banks has developed a quantitative approach so far, which is necessary for the definition of KRIs and for adequate reporting to the BoD. Moreover, very few intermediaries have incorporated climate and environmental factors into their ICAAP stress testing framework, Risk Appetite Framework (RAF) or recovery plan.

With specific regard to **credit risk**, some banks have started, or just planned, to integrate counterparties' climate risk exposure into their credit granting and monitoring processes. To this end, they have designed specific questionnaires to serve as the main data collection tool in the attribution of ESG scores. In some cases, the questionnaires are based on proprietary qualitative and quantitative methods, but they are more frequently prepared using external providers' software applications.

In this context, the majority of LSIs in the sample reported that they have launched or planned initiatives, which include participation in joint projects, to help gradually meet the supervisory expectations, especially with regard to business strategy, credit risk and investment services. However, virtually none of the intermediaries have incorporated these initiatives into a **structured plan approved by the BoD** yet (i.e. work projects, managers and timeframes).

3. Conclusions

In relation to the above, the Bank of Italy expects the banks' governing bodies to **approve a suitable action plan** for the next three years to set out a gradual process of alignment with the expectations, defining the timeframes for adapting the main corporate policies and organizational and management systems in a consistent way (see Expectation 1).

These action plans will be the benchmark for the **supervisory dialogue with the LSIs**. More specifically, the Bank will continue to examine and monitor the progress of the initiatives adopted and planned by the intermediaries involved in the survey, which are expected to approve the plan and provide it to the Bank by 31 January 2023, unless they have already done so. At the same time, discussions will begin with the banks not involved in the survey, whose deadline for producing an action plan is 31 March 2023.