Climate and environmental risks. Main findings of a Bank of Italy's survey on a sample of non-bank financial intermediaries

1. Introduction

In April 2022, the Bank of Italy published 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 (both physical and transition risks) into their **governance and control systems, business model** and **strategy**, **organizational system and business processes**, **risk management system** and **market disclosure**.[1] To this end, intermediaries were asked to examine and assess the relevance of climate-related and environmental issues to their own operations[2] and to design solutions that match the actual level of risk exposure based on the type, scale and complexity of their activities.

In conjunction with similar initiatives for less significant institutions (LSIs), the Bank of Italy distributed a self-assessment questionnaire to a sample of 86 non-bank intermediaries to determine to what extent climate and environmental risks have been integrated into their organizational systems, with specific regard to the following areas: (i) governance and organization; (ii) business model and strategy, (iii) risk management system; (iv) market disclosure.

As shown by an analysis of the responses, the expectations have been met to a limited extent. Despite the attention paid by firms' top management to environmental, social and governance (ESG) issues, widespread shortcomings were reported in most cases, with delays in the implementation and often in the planning of structural interventions on the different types of companies involved.

This report aims to provide an account of the problems that have arisen and urge non-bank intermediaries to continue to carefully assess their exposure to ESG risks and adopt action plans designed to encourage the gradual integration of climate and environmental risks into their corporate strategies, governance and control systems, and risk management frameworks in the medium term.

2. Main problems

---

[1] https://www.bancaditalia.it/focus/finanza-sostenibile/vigilanza-bancaria/en_Aspettative_di_vigilanza_BI_su_ESG.pdf?language_id=1

[2] Although the supervisory expectations relate to 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.

The list below illustrates the problem areas brought to light by the replies to the questionnaires, grouped into three analysis profiles: ‘Business model and strategy’; ‘Governance and organizational system’; ‘Risk management system and databases’.

As for the Business model and strategy profile, some weaknesses emerged with regard to the assessment of the impact of climate and environmental risks on the competitive environment and legislative framework within which individual firms operate. The majority of intermediaries had limited their actions towards the sustainability of their business model to adding ‘green’ or ‘socially responsible’ products to their offer. Little focus has been placed on achieving measurable business strategy sustainability goals and monitoring specific performance indicators, which were identified only by a reduced number of operators.

In this regard, given that analysing the market and its variables is crucial in order to properly design their business strategy, intermediaries are urged to carry out an in-depth and objective assessment of their material exposure to climate and environmental risks and examine how such exposure impacts their business model. In their assessment process, intermediaries should, as much as possible, combine quantitative metrics and qualitative assessments and use the findings, suitably formalized, to design comprehensive business strategies (or review the existing ones) that go beyond merely widening their range of products to include ‘green’ options. Intermediaries looking to incorporate objectives for combating climate change and safeguarding the environment into their business model should translate this commitment into measurable sustainability targets. Designing proper strategies is essential in order to monitor in a timely manner the actual progress made towards achieving the objectives through environmental and climate change performance indicators specific to the various business models adopted.

With regard to the Governance and organizational system profile, the degree to which the supervisory expectations are met varied among the respondents. While sustainability is the focus of the top management’s attention for most firms in the sample, a non-negligible share report their governance bodies being only partially involved or not at all. In particular, some weaknesses were revealed that are rooted in the governing bodies' lack of climate- and environment-related competences and in an inadequate reporting system.

The supervisory expectations require firms’ governing bodies to take an active and conscious role as regards climate and environmental risks and, in general, to add ESG experts to their ranks. To this end, it would be desirable for intermediaries to increase their commitment to vocational training: we can expect the subject to be fairly complex and ever evolving, both in terms of scientific knowledge and the regulatory framework, therefore training should be provided in a structured and ongoing basis and not just limited to sporadic initiatives.

Staying abreast of ESG-related issues also requires defining and formally assigning roles and responsibilities within the governing body and/or board committees and ensuring an effective reporting system with an appropriate frequency. Finally, there is a need to enhance the ability of remuneration policies to encourage forms of behaviour that help achieve ESG objectives, including through the identification of specific parameters.

From an organizational standpoint, the firms’ governing bodies should increase their efforts to identify the changes that need to be made to the organizational structures and operational processes, in a manner that is consistent with and proportionate to the assessments of the materiality of climate and environmental risks. More specifically, the following elements should be considered: i) creating and/or adapting corporate structures dedicated to environmental sustainability; ii) strengthening the involvement of the control functions in monitoring ESG risks; iii) integrating IT systems and creating a database that provides the information necessary to assess the exposure to climate and environmental risks.

As for the Risk management system profile, the intermediaries should step up their efforts to meet the expectations, by designing proper actions for the control functions. A very common problem is the scarce availability of reliable data that can be used to measure the risks; moreover, the quality of the information gathered mainly from external providers is not adequately assessed given the weak data governance strategies and insufficient integration of data into the corporate IT systems.

Supervisory expectations require systemic integration of sustainability risks into the corporate risk management system. To this end, intermediaries should map any and all risk events that may arise as a result of climate and environmental factors and assess their materiality and their prudential implications. Once these risks have been completely mapped, they should calculate the acceptable level of risk exposure by designing an adequate system of risk indicators and limits and, where it exists, incorporating the Risk Appetite Framework.

The intermediaries are called to focus on designing consistent monitoring and reporting systems, the latter intended also for top management. To this end, the search for good quality data needs to be intensified and robust data governance systems need to be put in place; for instance, the use of external data providers and non-proprietary rating systems must be coupled with adequate safeguards, in terms of source transparency, data updates, robustness of the estimation methods and adequate validation by the competent corporate structures, to ensure the accuracy of the information used.

The intermediaries should be more resolute when integrating these risks into their lending processes – which should be increasingly compliant with the principles set out by the EBA (see EBA/GL/2020/06) – and into their investment strategies. Asset management companies (managing either own or third-party portfolios) will need to enhance their ability to measure not only the level of 'sustainability' of investments, but also the potential impact on the pricing of adverse events linked to the materialization of climate/environmental risks.

In this context, greater efforts will need to be put in place to build stronger safeguards to counter liquidity and operational risks (legal and reputational risks and risks linked to the adequacy of the information systems).

3. Action plans

Intermediaries were also asked, through the self-assessment questionnaires, to outline the initiatives they had planned in order to meet the supervisory expectations in full. The analysis shows that, in most cases, a series of measures have been planned to strengthen the organizational safeguards, especially at top management level. These initiatives, however, have not proven to be entirely in line with the responses to the self-assessment questionnaire; the broad awareness of the need for adjustments to meet the expectations has not yet been translated into sufficiently detailed plans.

In light of this, intermediaries are called upon to prepare an 'Action Plan' that: (i) points out specific actions to be put in place to bridge the gaps identified; (ii) specifies the priorities and timeframe needed to complete the actions, taking into account the level of exposure to the risks and the size and complexity of a firm's operations; (iii) takes account of the weaknesses and need for improvement expressed in the self-assessment questionnaires, as illustrated above.

Upon approval by the Board of Directors, the Action Plan shall be submitted to the Bank of Italy, together with an assessment by the Board of Auditors, by 31 March 2023, and will be used in the Supervisory Review and Evaluation Process (SREP) which the Bank of Italy conducts annually on all supervised intermediaries.