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ESG factors in the financial system: the role of supervision

Ned Community
ESG risks in bank-company relations

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1. Why ESG issues matter for banks and financial operators

ESG (Environmental, Social and Governance) issues have long been a focus of attention for the world of finance: sustainable business models for intermediaries can in turn facilitate the progression of the economy and of society as a whole towards virtuous standards of social inclusion, environmental protection, and resilience to external and internal shocks.

They are, therefore, nothing new in and of themselves. What has changed with respect to the past, however, is the order of priority that ESG issues have acquired in the global political agenda and, consequently, the greater awareness of all stakeholders of their central role in ensuring the sustainability of business models.

The three ESG components are closely interlinked, but each has its own specificities, also because of how it has been incorporated within the supervisory framework so far. Governance has always been one of the main areas for analysis and intervention by supervisory authorities; the experience of recent years has confirmed that it is a key variable for the sound and prudent management of intermediaries and, therefore, for the stability of the entire system.

At the domestic level, last year the Bank of Italy updated its governance provisions, also with reference to the importance of ESG factors in corporate organization and management and to the diversification of banks' boards, introducing for the first time minimum quotas for the less represented gender. It also carried out a specific in-depth study of the governance systems of the banks it supervises, to identify good corporate practices and to expand the range of analytical tools for periodic evaluations of intermediaries. The main results will be communicated to stakeholders in the near future.

Regarding social issues, intermediaries' interactions with the various stakeholders imply a structural exposure to numerous risk factors. Unfair commercial practices, overly complex or speculative financial products and inadequate data security and privacy safeguards have triggered compensation obligations, reputational damage with loss of business, and negative impacts on income statements. Particularly tense market conditions, such as those we have been experiencing in recent weeks, can only increase the importance of these risk profiles further.

Lastly, there is the issue of the environment, a vital question for the future of the planet and one that also involves a particularly large number of public and private players in the financial sector. By now there is strong awareness of how much remains to be done, especially in the collection of empirical data and the refinement of suitable analytical tools; equally, a strong increase in demand for 'sustainable' products from investors has already become apparent. Banks are starting to integrate these factors into their business models, beginning with their internal operating processes. Partly at the urging of the supervisory authorities, a process is therefore under way to re-evaluate the impact of environmental risks on financial activities and on how they translate into traditional (e.g. credit, market and liquidity) risks.

These developments are being carefully monitored by supervisors, also taking into account the need to ensure maximum coordination, at all levels, to exploit synergies and avoid costly duplication. There is also an awareness of the need to ensure the necessary flexibility in implementation to take account of any changes in the external environment, as confirmed by ongoing international events.

Today I will focus on climate risks, detailing the numerous initiatives that international supervisory authorities and the Bank of Italy are pursuing and the challenges that await the financial system, including in its relations with the business world.

2. The role of banking and financial supervision of climate risks: defining the new regulatory framework

There is now broad consensus on the role of finance and financial operators in the climate transition process. As the Bank of Italy has pointed out on several occasions,[1] first and foremost, this process requires economic, regulatory and fiscal policy decisions aimed, among other things, at channelling the huge financial resources that will be needed to radically change the way we produce, transport and use energy.[2] It will therefore be crucial to ensure the full involvement of the financial system and rules and the supervisory controls designed to make certain that intermediaries manage their risks in accordance with the principles of sound and prudent management.

A first important lever is regulation (Pillar I). The Basel Committee – at the global level – and the European Banking Authority (EBA) – at the European level – are considering whether, and how, the current prudential framework should be revised. The EBA is also working on a consultation paper to foster constructive dialogue with the industry and to assess whether there is a case for introducing a specific supervisory treatment for ESG-exposed assets, while respecting the risk-based approach.

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1 L. F. Signorini (2022), 'Climate transition, finance and prudential rules', XVII Convention AIFIRM.

2 According to the International Energy Agency, worldwide investment in clean technologies will have to be tripled by 2030, reaching $4,000 billion: I. Visco (2021), 'Innovation and sustainability: challenges for the European and Italian financial industry from a post-COVID perspective'.

The Basel model also assigns a central role to the process of prudential supervision (Pillar II). In recent weeks, the public consultation on the Basel Committee's document 'Principles for the effective management and supervision of climate-related financial risks' was concluded. The document sets out eighteen principles for banks and supervisors and aims to promote best practices in climate risk management.

The decision to draw up non-prescriptive guidelines confirms the need to preserve the necessary flexibility at this stage, also in light of the wide variety in existing practices and their progressive evolution. The concrete transposition of the principles into ongoing activities should therefore be based on the criterion of proportionality, according to the size, complexity and riskiness of the individual bank.

The third area of intervention is that of disclosure to the market (Pillar III): this is largely new information, especially in terms of the level of detail that will be required.

First, on 10 March 2021, the new public disclosure requirements for financial firms set out in the Sustainable Finance Disclosure Regulation (SFDR) came into force,[3] which aims to promote market disclosure by financial services providers[4] and operators making investment recommendations;[5] in particular, it introduces harmonized rules to improve the quality of information and the comparability of products in terms of sustainability. As of June this year, large banks ('large institutions that have issued securities admitted to trading on a regulated market in any Member State') will be required to publish information on ESG risks.

Moreover, a few weeks ago, the EBA published its Technical Standards which provide further details, for example on exposures in the investment portfolio (the banking book). The document represents a further important step towards increasing awareness of the importance of reliable data on ESG factors; however, the EBA has envisaged a gradual approach, requiring only some information in the first few years compared with what will be required when they are fully implemented.

The data that banks will have to publish for the 2022 and 2023 financial years relate to the amount of exposures to sectors that contribute most to climate change and to the top 20 carbon-intensive counterparties. These data will be obtained primarily on the basis of information collected from credit processes and/or through service providers.

From 2024 onwards, banks will instead require additional information to be provided directly by the counterparties in their non-financial declarations (NFDs) governed by the Non-Financial Reporting Directive (NFRD) and, eventually, by the Corporate Sustainability Reporting Directive (CSRD). In this regard, the European legislator has foreseen that from 2023 onwards, non-financial

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3 Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector.

4 Investment firms (SIMs), banks and companies that provide investment consultancy services, insurance companies that provide consultancy on insurance investment products.

5 Investment firms (SIMs) and banks that provide portfolio management services, undertakings for collective investment in transferable securities (OICVMs), alternative investment funds (FIAs), European venture capital funds (EuVECAs) and European social entrepreneurship funds (EuSEFs), companies that make insurance-based investment products (IBIPs) and funds that offer pension products.

corporations obliged to prepare an NFD will publish indicators that can be used by banks to meet their Pillar III obligations.

Finally, the amendment contained in the recent EU Commission proposal to revise the CRD/CRR will extend the scope of application of ESG risk disclosure to all banks, regardless of their size, according to a 'proportional' approach.

In any case, there is a clear link between disclosure to the market by financial intermediaries and disclosure by funded counterparties that requires strong mutual cooperation to implement these important changes to the regulatory framework.[6]

3. Supervisory initiatives

Climate and environmental risks are now also among the priorities of the main international and national supervisory authorities.[7]

As early as November 2020, the SSM published a Guide for Significant Institutions (SIs), in which it set out its expectations on how to integrate climate risk into strategies, business models, governance processes, risk management, and the type of disclosure to be provided to the market.

The Guide was the first step in a process that was developed in 2021. Subsequently, self-assessment questionnaires were sent to SIs on the level of compliance with the expectations of the SSM and related compliance plans. The results of the exercise showed that no intermediary in the SSM was fully compliant. Italian banks performed broadly in line with the average, with more advanced practices in the areas of governance, risk appetite, organizational structure and operational risk management; no Italian significant banks were found to be 'inadequate'.

2022 will be no less intense; rather, it will be the year in which the knowledge and experience gained will allow climate risk to be incorporated into the day-to-day supervision of individual banks.[8]

In particular, a new thematic survey was recently launched to assess both the current consistency with supervisory expectations and the quality, effectiveness and complexity of banks' solutions to remedy the shortcomings identified in 2021. A specific stress test on climate risks has also been launched in recent weeks that will complement the results of the similar macroprudential exercise conducted by the SSM last year.

At the national level, the Bank of Italy has begun to consider environmental issues in its supervisory dialogue with less significant banks (LSIs), taking the same progressive

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[6] P. Angelini (2022), 'The recent proposal by the European Commission to change prudential rules for banks: an overview and initial assessment', ABI Executive Board, 19 January (only in Italian).

[7] See, for example, ECB Banking Supervision, SSM Supervisory Priorities 2022-2024.

[8] F. Elderson (2022), 'Toward an inmersive supervisory approach to the management of climate-related and environmental risks in the banking sector'.

and pragmatic approach. In particular, last year, in-depth analyses were conducted on an initial sample of LSIs in order to acquire information on the main initiatives taken and to assess, also through interviews with corporate executives, their awareness of the significance of climate risks; in fact, boards of directors play an essential role in defining, communicating and integrating climate risk into the corporate culture and overall strategy. The analyses carried out showed a growing awareness of the importance of ESG issues, though to differing degrees.

For asset management companies (SGRs), in-depth analyses were conducted of the strategies adopted, the range of products offered, the organizational set-ups and risk management processes. The organizational choices made by intermediaries were found to be on the whole proportionate and consistent with their size; however, other aspects still need to be assessed, such as the functioning of governance bodies, the actual amount of resources dedicated to ESG activities, the level of integration between the various organizational units, and the effectiveness of checks carried out by control functions.

In the course of 2022, the Bank of Italy will intensify its supervision activities on climate risks, in line with the high degree of priority given to the issue; for example, a first version of the supervisory expectations for LSIs and financial intermediaries will be published in the coming weeks, which will cover strategic planning, governance, organizational safeguards, risk management systems and levels of disclosure transparency.

Intermediaries will have to carefully check their preparedness on these issues, possibly defining action plans to fill the gaps identified, but will have margins of flexibility in finding appropriate solutions; the identification of best practices will also allow the framework to be progressively adapted.

The Bank of Italy has also taken part with a sample of LSIs in the thematic survey of SIs that the SSM is carrying out; starting from the second half of the year, similar self-diagnosis initiatives may concern the entire system. In the medium term, climate risks will be included in regular supervisory dialogue as part of the periodic assessments of individual intermediaries. A similar self-assessment initiative will be addressed to non-bank intermediaries.

4. Risks and opportunities for the financial system

As already mentioned, banks will have an essential role in facilitating the reallocation of the financial resources needed to support the transition to more sustainable economic systems.

Intermediaries that are fastest at properly integrating ESG factors into their investment processes, lending decisions and dialogue with clients will be able to gain a competitive advantage in seizing the opportunities offered by the transition in terms of growth in high-quality lending, expansion of client services, and effective management of ESG risk factors. Conversely, those that lag behind, in addition to being penalized in their market positioning, may find it difficult to govern the quality of their portfolios going forward, and ultimately find themselves more exposed to ESG risks.

The ability to identify the sectors of economic activity, counterparties and projects most exposed to climate risks will increasingly become an essential element in making an informed contribution to financing the transition.[9]

In the coming years, different dynamics on both the supply and demand sides could lead to increased growth in the financing of transition projects.

On the supply side, the progressive introduction of more transparency requirements will prompt banks to assess financing operations also on the basis of sustainability: financing green sectors/projects will allow banks to improve their published ESG indicators which, in turn, may influence their ability to attract financial resources.

On the demand side, the greater transparency imposed on large and listed companies by the CSRD will increase requests for funding for projects to transition towards more sustainable models, also aimed at preventing the risk of greater future difficulties in accessing credit. The same motivation will also progressively push firms that are not subject to regulatory obligations to voluntarily increase transparency regarding their sustainability characteristics and to request financial resources to adapt their business models.

In the asset management sector, the main global asset managers are accelerating the adaptation of investment processes, completely redesigning their portfolios under management, in order to increase the share of green compliant products. In 2021, flows from mutual funds managed by Italian intermediaries towards sub-funds promoting ESG investments amounted to €34 billion; the assets of these funds reached €158 billion, almost a quarter of total assets. This trend is set to continue in the coming years.

In this context, there are three areas in which financial intermediaries will have to make the greatest progress, especially at this stage: credit processes, investment processes, and data collection and management.

First, incentives to finance the transition must not lead to a general lowering of credit standards, but should rather stimulate a strengthening of credit standards through the integration of ESG factors into the dataset used. Intermediaries will therefore need to be able to assess firms with adequate creditworthiness that require funds to adapt their business models and the weaker ones that could face greater difficulties when making the transition.

The sustainability and credibility of transition projects will also need to be carefully considered, e.g. by collecting adequate information on the company's climate change objectives, assessing the consistency of financing projects, and regularly monitoring the proper allocation of proceeds. Poor controls can lead to an underestimation of risk and also damage the reputation of intermediaries.

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9 G. Siani (2021), 'The impact of the implementation of the Action Plan on Sustainable Finance', Sustainable Development Festival (ASVIS), 6 October (only in Italian).

The integration of ESG criteria into credit decisions is therefore a concrete and current need with elements of considerable complexity. In fact, it necessarily concerns the entire credit cycle, starting from planning and credit policies, and then involving commercial practices and disbursement processes, risk management systems, and recovery strategies.

Initiatives to integrate ESG factors are, of course, linked to ongoing digitization projects. The need to automate and speed up response times remains a priority in order to reduce the cost of customer services while increasing its quality. A further challenge in the near future will therefore be the convergence of these two project strands, which is essential to exploit the related synergies.

As far as investment processes go, increased investor demand could lead to overpricing, followed by sudden corrections. In addition to market risk, there is the potential reputational risk arising from greenwashing, whereby intermediaries finance activities that are only apparently sustainable.

Processes for investing in financial instruments must therefore be strengthened by defining clear and unambiguous criteria for taking climate and environmental risks into account in investment selection strategies, which are consistent with the characteristics of the products offered.

Finally, there is the issue of data collection and management. The availability of reliable and comparable information is an essential element in completing the transition process and in allocating financial resources consistently. In particular, it will be necessary to have a large quantity of sufficiently detailed data on the evolution of the phenomena investigated.

The challenge is therefore a complex one, bearing in mind that the availability of data is currently unsatisfactory. For example, the lack of comparability between data bases provided by external parties and the different degree of coverage of the firms are significant. The challenge of bridging this data gap is exacerbated by the existence of numerous small enterprises, for which there are considerable information gaps.

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The ecological transition towards net zero is shared by financial intermediaries, firms and supervisory authorities. The evolution of management systems towards greater transparency and longer time horizons requires greater information sharing and stronger bank-company relationships.

On the one hand, financial intermediaries must guide companies along this path; on the other, firms must be reliable travel companions. The relationship must therefore be based, even more than in the past, on mutual trust and knowledge.

In order to steer the economy towards sustainable development, it is essential that banks guarantee correct conditions of access to bank credit, by assisting businesses, especially smaller ones, in their projects with new finance and advisory services, and progressively integrating creditworthiness assessment criteria with sustainability indicators.

Everyone must contribute to this effort, which will require determination and clear objectives but also a gradual and pragmatic approach. Within the scope of its competences and prerogatives, the Bank of Italy will continue to work in this direction in the international regulatory debate, in its supervisory activities and in the broader initiatives on environmental sustainability that are under way at central bank level too.

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