BANCA D'ITALIA
EUROSISTEMA

ESG: state of the art

The supervisory perspective

Milano, 29 marzo 2023

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Agenda of the presentation

1) Overview of the regulatory framework

2) ECB and Bank of Italy supervisory action

3) Key point of attention and good practices

1) Overview of the regulatory framework

- BCBS. Principles for the effective management and supervision of climate-related financial risks (June 2022; see also FAQ published last December).

- EU Banking Package (CRR3-CRD6) ⇒ Banks are required, inter alia, to:
  a) identify, disclose and manage ESG risks as part of their risk management;
  b) develop plans to address ESG risks and consider them when defining strategies and internal processes;
  c) disclose information on ESG (art. 449a).

- EBA. Role of environmental risk in the prudential framework (EBA/DP/2022/02) ⇒ Report to the Commission on whether to incorporate a special prudential treatment for exposures affected by environmental and social factors.

- Bank of Italy ⇒ the revision of the prudential framework should be risk based and leverage on the flexibility of Pillar 2; consistency between the various disclosure requirements and proportionality must be ensured.

2) ECB and Bank of Italy supervisory action

The supervisory authorities have launched various initiatives to stimulate the banking and financial system to integrate climate and environmental risks into corporate strategy, governance, risk management and internal control system:

- ECB Guide on Climate-Related and Environmental Risks (November 2020) ⇒ how the ECB expects banks to prudently manage and transparently disclose such risks under current prudential rules.

- ECB request to SI for a self-assessment (early 2021) of their current practices against supervisory expectations and the submission of the implementation plans. Following the supervisory dialogue (August and September 2021), all institutions received a feedback letter outlining the main shortcomings as well as an overview of peer benchmarking.

- Bank of Italy supervisory expectations (April 2022) regarding both banking and financial supervised intermediaries.

2) ECB and Bank of Italy supervisory action

- The ECB thematic review on climate-related and environmental risks (November 2022) of 186 banks (SI and LSI). The ECB has set institution-specific deadlines for achieving full alignment with its expectations by the end of 2024.

- Bank of Italy took part in the ECB thematic review with a sample of 21 LSI. As a follow up, Bank of Italy asked all LSI to draw up an Action Plan (to be submitted by the end of January 2023 - March 2023 for LSI not included in the sample) that will have to include the measures to be taken to address any identified gaps.

- Bank of Italy self-assessment questionnaire involving a sample of 86 non-bank intermediaries, including 40 asset management companies (SGRs) . The outcome of the review has been published last January 2023, jointly with the request of a remediation plan to be submitted by end of March 2023.

3) Key point of attention – ECB Thematic Review

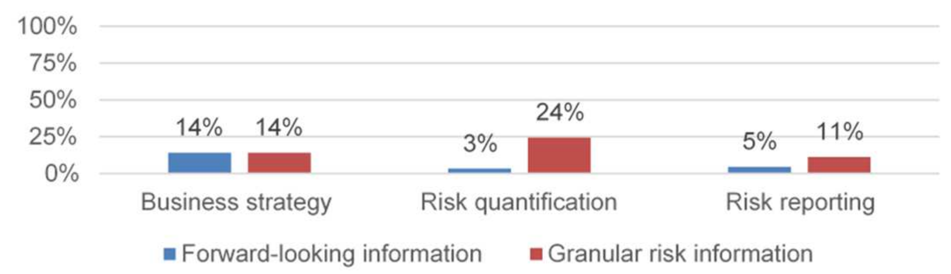
The **main findings of the ECB Thematic Review**:

- There is broad acknowledgement within the banking sector of the materiality of physical and transition risks: for more than 80% of institutions these risks have a material impact on their risk profile and strategy.

- However, banks are still far from adequately managing climate and environmental risks. Even if 85% of banks have in place at least basic practices in most areas, they are lacking more sophisticated methodologies and sufficiently granular and forward-looking data (less than 10% use sufficiently forward-looking/granular C&E risk information).

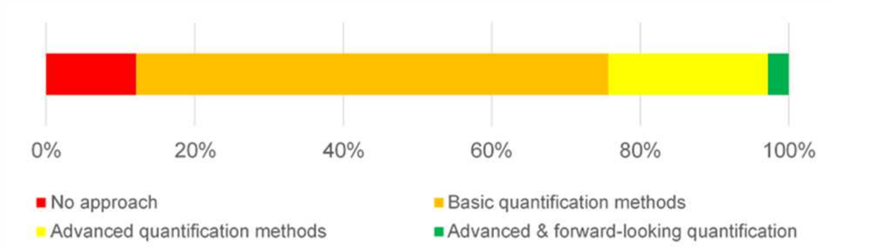
The use of forward-looking and granular C&E risk information in selected practices

(percentage of institutions)



Quantification methods for climate-related risk management

Percentage of institutions with an approach in place for the quantification of climate-related risks



3) Key point of attention – ECB Thematic Review

- Almost all the banks (96 per cent) show blind spots in identifying C&E risks in key sectors, geographies and risk drivers (60% were considered to be major gaps).

- There are gaps in integrating C&E risks into business strategies, decision-making and internal control processes.

- Long-term strategic commitments are not supported by intermediate targets, limits and thresholds and there is concern on the execution capabilities (55% have devised practices but failed to implement them effectively).

- Smaller institutions have greater resource constraints compared with larger institutions and show a relatively large dispersion in terms of performance, with many having developed advanced practices.

- The results of the Italian significant banks are consistent with the overall dynamics of the SSM banks.

3) Key point of attention - LSI

The **main findings of the Thematic Review on LSI**:

- Low degree of alignment with expectations, but growing awareness of the importance of C&E risk for the sustainability of the business models (on the agendas of almost all the boards of directors);

- Difficulty in obtaining robust and reliable data is the main point of attention in all the areas of investigation. Only few banks have launched comprehensive data collection and management projects. As a consequence:

  a) materiality assessments are conducted essentially on a qualitative basis;

  b) risk management, also due to poor quantitative metrics, is the area with the most significant shortcomings;

  c) quality of reporting is often poor;

  d) external data providers play a key role.

- The majority of the LSIs has started initiatives to promote a progressive alignment with expectations, but almost no intermediary had set out these measures in a structured plan at the TR reference date (hence the request of the Plan mentioned in slide 5).

3) Good practices

- **Business strategy**. Use of advanced transition pathways to better steer the strategy:
  - by setting intermediate and longer-term targets using forward-looking tools (to avoid the build-up of excessive transition risk in their portfolios);
  - by fully integrating the target-setting process in the institution's governance, risk appetite and risk management framework and in the types of products and services offered to clients.

- **Governance**. Adoption of a structured approach for strengthening ESG data governance (data gap analysis; data collection strategy and data management and reporting framework). In particular, institutions:
  - collect client and asset-level data (e.g. data on water consumption intensity and fossil fuel dependency);
  - use these data to develop granular risk indicators, which are reported to the management body and are also integrated into institutions' variable remuneration practices;
  - design a structured process for the acquisition of data from external providers.

3) Good practices

- **Risk Management**. Allocation of economic capital to the management of physical and transition risks and integration of C&E risk in their rating system. In particular:
  - Inclusion of C&E risks in internal ratings-based models, for example by using qualitative variables or rating overrides in their PD rating systems;
  - In such cases, risks may also be reflected in loan pricing via credit and funding cost price calculations or through expected profit margins.
- **Materiality assessment**.
  - Identification of risk drivers. Bottom up risk identification process relying on both internal and external sources and use of heatmapping to determine the severity of each risk drivers;
  - Identification of exposures. Use of scenario analyses to assess the impact on either probability of default (e.g. through changes in client revenues/costs) or loss given default (e.g. through changes in the value of collateral);
  - Determination of materiality. Definition of one or more threshold and conduct of focused deep dives for the determination of material risks, followed by a customized strategic response.