Climate-related and environmental risk

Overview of the ECB’s recently published Draft guide on climate-related and environmental risks

June 2020
Draft ECB Guide on climate-related and environmental risks

ECB plans short timeline until final Guide & application in SREP

Timeline

Draft ECB Guide on climate-related and environmental risk published for formal consultation on May 20th, 2020

Feedback by firms until September 25th

YE 2020: Firms to inform the ECB of any divergences from the supervisory expectations


ECB expects significant banks to be compliant and to promptly start adapting their practices in case of non-compliance

NCAs to apply expectations proportionately – ECB Guide expected to be consistent with existing NCA guidance (e.g. BaFin, DNB, FMA)

Review of compliance in SREP

Based on ECB’s stock take of current practice, we expect significant implementation efforts for firms to meet ECB’s expectations.

“… institutions have predominantly approached the topic from the perspective of corporate social responsibility and have yet to develop a comprehensive risk management approach.”

(ECB Guide on climate-related and environmental risks, observations from stock-take, page 13)
Draft ECB Guide on climate-related and environmental risks

ECB’s 13 high level expectations … cover the whole risks management universe

Most components of bank’s risk management will need revision to incorporate environmental risks – including all levels of policies & procedures, but also methodologies & infrastructure.
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ECB applies existing regulation to an emerging risk driver and declares it material

“... when an institution assesses that ... risks do not significantly contribute to material risk types, a classification as non-material risks is justified.”
( expectation 7, page 29)

“... risks are not expected to be excluded from the assessment because they are difficult to quantify or because the relevant data are not available.”
( expectation 7, page 29)

The ECB’s rationale is clear

Key Assumption:
Climate-related & environmental risks are material to banks

Banks should have processes to identify and integrate material emerging risks

Material risks are subject to a wide range of regulations

Guide only states ECB’s interpretation of compliance with applicable standards

Divergence from guide a priori equivalent to non-compliance with existing standards

— No transitional period required, guide instantaneously applicable
— No significant changes expected from consultation

As consequence, ECB grants no transitional period to meet its expectation from end of 2020 onwards – little to no changes are expected from consultation phase.
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Challenging expectations: Active efforts required to develop or apply appropriate tools & methods for quantification

As the field “…is evolving rapidly, institutions are expected to regularly consider the appropriateness and quality of the data sources and methods in place” and “take into account up-to-date scientific insights”

Developing the tools needed to assess climate-related and environmental risks requires new data sources and models typically not yet used in banks’ risk management.

( ECB Guide on climate-related and environmental risks, expectation 7, page 31/expectation 1, page 16)
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Challenging expectations: Climate-related scenarios require a much longer time horizon to analyze the impact

“A longer-term assessment beyond the typical business planning horizon …would be required to capture the specificities of this kind of risk.”

(expectation 2, page 17/18)

“Only a few institutions include climate-related risks in their stress testing … the practice of assessing the capital impact and the capital requirements, should such risks unfold, remains limited.”

(ECB Guide on climate-related and environmental risks, observations from stock-take, page 13)

Extending the scenario horizon to 30 years and more require dynamic balance sheet modelling – and a significant overhaul of many firms’ scenario capabilities and infrastructure.

“All these aspects should be properly reflected in an institution’s ICAAP”

(expectation 11, page 37/38)
Challenging expectations: Thorough integration into credit risk management and processes

"... to be aware of their clients’ impact on and vulnerability to climate-related and environment aspects and of their approach to managing this impact and risks" and "... adjust risk classification procedures" (expectation 7/8, pages 30-33)

"... reflect the different costs driven by climate-related and environmental risks" (green bonds) and may consider "discounts on the interest rate of an environmentally sustainable loan or reflect the "achievement of a sustainability target by the client" (expectation 8, page 32/33)

"... to monitor how geographic and sectoral concentration is prone to climate-related and environmental risks" (green bonds)

"... to consider climate-related and environmental risks in their collateral valuations" and "give particular consideration to the physical locations and the energy efficiency of ... real estate" (expectation 8, page 32/33)

"... to consider climate-related and environmental risks at all stages of the credit-granting process" (expectation 8, page 31)

"... to conduct a proper climate-related and environmental due diligence, both at the inception of a client relationship and on an ongoing basis." (expectation 7, page 30)

Integrating environmental risks into credit risk management in line with LOaM requires changes along the entire credit process and many tools, methodologies and the underlying data.
## Draft ECB Guide on climate-related and environmental risks

**Need for action on all time horizons to reach ...**

<table>
<thead>
<tr>
<th>Short Term Goals (Quick Wins)</th>
<th>Medium Term Goals</th>
<th>Long Term Goals</th>
</tr>
</thead>
<tbody>
<tr>
<td>— Define Management Board involvement and firm-wide governance for climate-related and environmental risks</td>
<td>— Set of relevant KPIs and associated methodologies defined</td>
<td>— Overall stabilization of new processes and methodology</td>
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<tr>
<td>— Gap analysis resulting in a clear action plan</td>
<td>— Significant increase in available data, incl. client due diligence</td>
<td>— Full integration of related data requirements and KPIs in the IT of the bank</td>
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<tr>
<td>— Initial materiality assessment of climate-related and environmental risks</td>
<td>— Full run of risks assessment to include in-depth analysis of climate-related and environmental risks</td>
<td>— Matured methodology for long term scenario analysis implemented</td>
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<tr>
<td>— Initial integration into business strategy, RAS, risk management framework and credit risk management</td>
<td>— Environmental risk related KPIs and thresholds included in business strategy, RAS, and reporting</td>
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<tr>
<td>— Enhance 2020 year end disclosures</td>
<td>— ICLAAP considers environmental risk scenarios</td>
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</tbody>
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KPMG can help you to reach these goals!

Risk Analysis & Heatmap
— With the KPMG ESG Risk Tool we will help you to conduct an initial impact analysis with respect to climate-related and environmental risk
— Based on a resulting heatmap of affected portfolios we will support further prioritization

Insights & Benchmarking
— Access to subject matter experts from various disciplines brings benchmarks information and specialized expertise together whenever needed
— In particular, KPMG’s Global ESG Initiative and KPMG’s ECB Office provide you with relevant information on ESG topics and answers to pressing issues related to the SSM

Comprehensive Risk Management Expertise
— Experience from OSI and risk management audits enables us to integrate these new risks into your risk management framework in line with supervisory expectations
— Based on our experience in implementing scenario analysis and risk models we will support you to develop methods and processes for quantification and simulation

Cooperation with Data Providers
— KPMG has entered into cooperation with specialized data providers, e.g. Southpole, which are able to expand climate-related scenarios in terms of local effects
— We will assist you to gather relevant data and define climate-related scenarios

Holistic view on ESG risk
— Current supervisory pressure is focused on climate-related and environmental risks, other ESG risks are on the further supervisory agenda
— Our holistic approach to ESG ensures that further developments are taken into account
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