Development of Tools and Mechanisms for the Integration of ESG Factors into the EU Banking Prudential Framework and into Banks' Business Strategies and Investment Policies

Executive Summary

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Abstract

This study, conducted on behalf of the European Commission, explores the integration of ESG factors into banks' risk management processes, business strategies and investment policies, as well as into prudential supervision. It provides a comprehensive overview of current practices and identifies a range of best practices for the integration of ESG risks within banks' risk management processes and prudential supervision. It outlines challenges and enabling factors associated with the development of a well-functioning EU market for green finance and sustainable investment. The study is based on the collection and aggregation of information from a wide range of representative stakeholders, in order to reflect a full spectrum of views. Findings show that ESG integration is at an early stage, and the pace of implementation needs to be accelerated in order to achieve effective ESG integration into banks' risk management and business strategies, as well as prudential supervision. To support this acceleration, enhancements are particularly required on ESG definitions, measurement methodologies, and associated quantitative indicators. A lack of adequate data and common standards remain key challenges to be overcome to drive ESG integration. Cross-stakeholder collaboration, as well as supervisory initiatives and guidance, will be critical in tackling this global and pervasive topic.

Executive Summary

Context and structure

This study provides an assessment of current practices for integrating environmental, social and governance (ESG) factors into the EU banking prudential framework as well as into banks' risk management, business strategies, and investment policies. Its main purpose is to enhance the understanding of ESG risks and their relevance within the financial system. The study was conducted as a comprehensive stocktake to collect and aggregate information from a wide range of representative stakeholders, including banks, supervisors, regulators, international organisations, civil society organisations, and academics, in order to reflect a full spectrum of views. The study reflects input and perspectives gathered from more than 150 stakeholders through desk research, focus groups, structured questionnaires and interviews, and workshops. Feedback in the form of questionnaires/interviews was received from 28 banks, 15 supervisors and regulators, and 15 international organisations, civil society organisations, and other stakeholders. For the purpose of this study, input received from questionnaires/interviews was not fact checked.

The study's objectives are to identify modalities of (1) integrating ESG risks into EU banks' risk management processes; (2) integrating ESG risks into EU prudential supervision; and (3) integrating ESG objectives into EU banks' business strategies and investment policies.

The study first provides an overview of current approaches to integrate ESG risks into banks' risk management and banking prudential supervision, and subsequently identifies relevant principles of best practices. The study then summarises current banks' strategies to integrate ESG objectives in their lending and investment activity. It concludes with an overview on the impediments to the development of well-functioning EU markets for green finance and sustainable investments, and illustrates enabling factors to promote the scaling-up of these markets.

Findings

Overall integration of ESG within banks' risk management and investment practices, as well as prudential supervision, is at an early stage. EU-wide legislation and regulatory activities have played a key role in the first steps towards promoting integration, alongside voluntary and market-based initiatives. Further alignment and coordination of efforts is required to advance ESG integration.

Integration of ESG risks within banks' risk management

A common and granular definition of ESG risks among banks does currently not exist. Few banks have developed a detailed list of ESG factors with a mapping to specific sectors, geographies, and client segments, in order to understand their relevance as drivers of risk. Most banks plan to assess ESG risks through both financial materiality and the material impacts of their activities on environmental and social issues ("double materiality"), which is the perspective advocated by civil society organisations.

Banks have not yet developed a clear mapping of how different ESG factors feed into financial risk types. While most banks are making efforts to map ESG risks to traditional financial and non-financial risks, levels of advancement among banks differ across the E, S, and G pillars. The most significant progress can be observed on climate-related risks, which are often mapped to financial risk types. Other ESG risks tend to be viewed through the lens of reputational or strategic risk. Banks indicated a lack of clarity as to whether traditional risk types can fully capture risks from an environmental and social materiality perspective. Most banks consider ESG risks as transversal, rather than as a principal risk type.

While most interviewed banks mentioned that they have refined their governance to define ESG risk responsibilities at board, executive, or management level, few banks appear to have an explicit and comprehensive ESG risk strategy in place. There is no single governance structure that appears to be a standard, although elements such as ongoing training, managerial incentives and sponsorship from executive level are typically considered core features. Whilst many respondents acknowledged the importance of developing a holistic ESG risk strategy, few banks have an explicit and comprehensive strategy in place that ensures coordination between the ESG pillars and visibility on potential trade-offs. Environmental and social risks are often grouped as part of sustainability risks, whereas the governance aspect is more often viewed as a compliance topic and therefore tends to be structurally and conceptually separated.

A comprehensive and robust data basis is considered a key requirement for advancing ESG risk integration within risk management processes. The quantitative and qualitative information that needs to be captured for ESG risk measurement is very broad, and banks apply different approaches to source data. Most banks use a combination of client and third-party sourced data. However, coverage of third-party data is often limited for smaller counterparties. Whilst already used by the majority of banks, increased reliance on third-party sourced data is expected in the future. Data points for the environmental pillar, in particular for climate-related risks, are more detailed and include for example scenario-related data, information on production capacity, and data on geolocation of assets. Regarding climate-related risks, participants often expressed a preference for third party data, as this fosters comparability, saves resources and effort, and allows banks to rely on approaches grounded in climate science.

Banks' measurement of their exposure to ESG risks is very limited. Banks conduct targeted pilot exercises but do not embed ESG risks into business as usual practices. The scope of these exercises tends to be limited to high-carbon sectors and does not usually cover the entire balance sheet. Initial efforts to assess climate-related risks and impact are conducted via approaches focusing on transition and physical risk – measuring the possible financial impact of climate-related risks through scenario analysis –, and through Paris pathway alignment and net zero approaches that use reference scenarios to assess the portfolio's alignment to temperature-related goals. Further investment in these capabilities is required to enable a comprehensive measurement of ESG risks.

The current degree of ESG integration in banks' risk management processes is limited. ESG factors are widely, albeit sometimes superficially, integrated within lending policies, credit application processes, and due diligence, in particular for selected high-risk sectors. However, coverage is often limited and, for example, off-balance sheet investment activity associated with advisory or debt capital markets is often not in scope. There is partial integration within portfolio monitoring and steering processes, and most banks do not have an aggregate portfolio view of their exposure to ESG risks.

Integration of ESG risks into risk models and stress testing is at an early stage. Further development of quantitative approaches within banks' risk management frameworks is required. In general, ESG risks are included in the Risk Appetite Framework through qualitative statements. Some banks conduct climate scenario analysis on selected segments of the portfolio, but rarely as a group-wide scenario analysis effort. A number of banks argue that they do not integrate ESG risks fully into risk processes as they are not found to be material in light of the long-time horizons that characterise ESG risks. While the horizons for ESG risks are longer than typical capital planning projections, sudden changes, such as policy developments, can materialise in the short term and could have a significant impact.

Most banks have not integrated ESG risks within their internal risk reporting frameworks. The highest degree of integration is observed for the E pillar, specifically on climate-related risks. ESG risk-related information is usually included in banks' public ESG disclosures, influenced primarily by national and EU-wide legislative and regulatory reporting requirements. Disclosures by banks tend to be qualitative, with further development needed to reach international and upcoming regulatory standards such as the Directive on Corporate Sustainability Reporting (CSRD) proposed by the Commission, and civil society expectations. For example, disclosed quantitative metrics are often linked to funding volumes in specific sectors or ESG products, rather than measuring exposure to ESG risks.

Integration of ESG risks within prudential supervision

There is no common ESG definition among supervisors. Although some supervisors have developed high level ESG definitions, many EU supervisors indicated their intention to observe the work of the European Banking Authority (EBA) and follow issued guidance in this respect. Supervisors tend to assess ESG pillars and specific risks within each pillar separately, as opposed to adopting a holistic assessment of ESG risks.

There is debate amongst supervisors as to whether the double materiality perspective should be adopted when looking at ESG risks. The majority acknowledge the importance of considering the environmental and social impact of banking activities. Others maintain that the focus of prudential supervision should remain on financial materiality by virtue of their supervisory mandate. There are also differing views among supervisors as to whether ESG risks should be viewed as a principal risk, or as a driver of existing risk types. Supervisors have not yet conducted comprehensive analysis as to how ESG risks, beyond climate-risk, propagate through established financial and non-financial risk types, although credit risk was usually mentioned as having the highest relevance.

The majority of supervisors have not yet defined quantitative indicators for the measurement of ESG risks. However, it is acknowledged that quantitative indicators and the measurement of ESG risks form an important part of supervisory oversight. At this point, supervisory ESG risk assessment remains focused on the qualitative elements typically used to assess risk processes within a bank, such as the integration of ESG risks within a bank's business model, governance, and strategy.

Few supervisors have developed dedicated and publicly communicated ESG prudential strategies. There are also differences in prioritisation: Some supervisors prefer to approach ESG holistically, whereas others have prioritised a specific element, such as climate-related or environmental risks. Internal capabilities to support a comprehensive approach to prudential supervision of ESG are not yet fully developed.

ESG risk measurement and scenario analysis are key for integration into supervision but impeded by the early stages of development of ESG definition, data, and quantitative indicators. Few supervisors have begun categorising assets based on their ESG risk profile. There is a focus on the E pillar and in particular the differentiation between green, brown, and grey exposures and activities. The EU taxonomy is seen as a tool to support this approach. Many banks, supervisors, and civil society organisations believe an expanded taxonomy will be needed in order to be used in a risk management context.

There are differing levels of advancement among supervisors in relation to the assessment of ESG risks. The Supervisory Review and Evaluation Process (SREP) is considered the primary tool to assess ESG risks within the current supervisory framework, and all prudential supervisors will expect banks to consider such risks in their Internal Capital Adequacy Assessment Process (ICAAP). However, only a limited number of supervisors have already explicitly integrated ESG risk considerations within Pillar 2 processes or as part of ongoing supervisory oversight. Few supervisors have begun considering ESG risks in supervisory stress testing, focusing on climate-related risks. This is usually done in the form of pilot stress testing exercises. None of the supervisors interviewed as part of this study have indicated plans to use climate stress testing for setting capital requirements at present.

EU-based supervisors await the outcome of the EBA mandates related to Pillar 1 and Pillar 3 of the Basel Accord. To this end, many interviewed supervisors consider it premature to attempt the integration of ESG risks into national or EU-wide regulatory requirements prior to the conclusion of these mandates. The EBA mandate to assess whether a dedicated prudential treatment of ESG risks is warranted (Pillar 1) is due to be fulfilled by 2025. In this context, civil society organisations urge an accelerated implementation of more stringent climate-related measures, particularly in light of the climate emergency declared by the European Parliament in 2019.

Many supervisors do not currently consider Pillar 1 tools as the best suited to address ESG risks, while a number of civil society organisations see capital requirements as an effective tool. The main reason given by supervisors is that robust quantitative evidence for a risk differential e.g. for green and brown assets is yet to be established. On the other hand, a number of civil society organisations argue that capital requirements should also play a role in incentivising banks to redirect capital to more sustainable sectors and investments, for example by means of a green supporting factor (GSF), a brown penalizing factor (BPF), or both. Some supervisors view this as a policy biased approach that could have unintended consequences on financial stability. While some civil society organisations see this as a lever to reorient capital, others contend that this would have a limited effect. The use of a BPF is preferred by some civil society organisations, as this could better reflect potential underlying risks on the balance sheet.

The communication of ESG-related supervisory guidelines, expectations, or best practice approaches plays an important role in ESG integration within the prudential framework. Common guidance would provide clarity and harmonise banks' practices. Many supervisors have already published such guidance; topics typically covered include ESG risk definition, governance and strategy, risk management, and disclosure. Supervisory engagement is seen as a crucial element in fostering capacity building and increasing ESG risk awareness in supervised institutions.

Integration of ESG in banks' business strategies and investment policies

While banks continue to evolve their offering of ESG-related products and services, such as sustainable bonds and green project finance, many ESG-related offerings are still under development or offered only by a small group of banks. Current ESG product offering includes capital markets solutions such as green, sustainable and social impact bonds, corporate and SME lending such as green project finance and green corporate loans, and products for individuals and microbusinesses such as energy efficiency mortgages and electric car loans. Banks see more innovative products, such as ESG-linked loans or transition loans, as growth opportunities. Various stakeholders encourage the integration of ESG factors into the full range of products and services offered by banks, including off-balance sheet exposures.

While most banks state that they are planning to integrate ESG factors into their lending and investment activity as part of a broader ESG strategy, adequate monitoring and targets (e.g. Paris Agreement goals) are still often lacking. Banks are expecting to continue to develop their ESG integration, for example through the endorsement of market-based initiatives, or adherence to international standards or treaties such as Paris Agreement goals. However, such ESG-related objectives and commitments are often formulated at a high level and lack adequate monitoring and targets. Most banks have been reviewing their governance arrangements and have established centralised sustainability teams or functions to drive group-wide ESG integration.

Portfolio analysis of banks' ESG lending and investment activity, if available, is often limited to certain sectors and product types. Measuring portfolio exposure to renewables, by loan-purpose, and to certain asset classes, such as green bonds, is more common and better understood. Approaches to measure and monitor a portfolio's ESG characteristics at a more granular level, for example distinguishing clients based on their ESG performance, are narrower and focused on certain instruments like securities. Despite most banks stating that they have integrated ESG in their lending and investment activities at least partially, there is a need to further develop approaches to actively steer the portfolio towards ESG goals.

Most banks have not yet collected comprehensive evidence on the risk/return profile of their ESG lending or investment activities. There are indications in academic research that there is a negative correlation between credit spreads and ESG scores in markets for sovereign and corporate bonds.

Observed challenges

Data challenges and a lack of common standards continue to be seen as the most prevalent challenges facing banks and supervisors alike. ESG data are the cornerstone for performing a wide range of ESG-related activities, including risk measurement, product labelling, portfolio steering, and disclosure. The absence of common standards for ESG-related issues impedes comparability of information received and disclosed by banks, which creates information asymmetry amongst market participants.

There is a lack of harmonised definitions and classification standards for a wider range of ESG products at a global level. Despite the development of international voluntary principles for some ESG market activities like green bonds, products are not always structured according to the same criteria. This hinders product comparison and effective asset allocation by banks.

Limited internal resources and capabilities are an impediment to ESG integration. This is a general observation, which is relevant for all three areas of the study, i.e. banks' risk management, prudential supervision, and the development of ESG products and services.

Conclusions

Despite increased efforts by banks and supervisors, this study finds that the pace of implementation to achieve effective ESG integration within risk management, prudential supervision, and business strategies and investment policies needs to be accelerated. Collaboration between all stakeholders will be required, including sufficient supervisory guidance and engagement, and cross-bank collaboration. Principles of best practice and enabling factors to support further ESG integration highlighted by study participants are summarised below.

Principles of best practice for integrating ESG in risk management and prudential supervision

Banks and supervisors should work to develop coherent definitions of ESG risks and consider the double materiality perspective. This definition should consist of a granular list of underlying factors under each of the ESG pillars and create a common framework for the understanding of such risks. At the same time, it should allow for geographic or business model related idiosyncrasies. ESG definitions should consider the double materiality perspective and be continually reviewed. To this effect, banks and supervisors should gather input from external stakeholders including civil society organisations to complement and balance perspectives.

Many stakeholders demand that banks and supervisors should develop ambitious, publicly stated ESG risk strategies with measurable objectives, priorities, and timelines. For banks, public commitments would foster accountability in relation to their progress on ESG risk integration and related strategic objectives, such as alignment with the Paris agreement. Supervisors should provide guidance to banks in relation to the development of such strategies, thereby also fostering capability building. Banks and supervisors will need to develop internal capabilities, requiring ESG-related training, methodologies, and data to implement these strategies. In addition, ESG KPIs could be included in managerial incentives.

Although the importance of ESG-related data has been widely recognised, banks should make significant efforts to enhance data quality, availability and comparability, as well as infrastructure improvements. This would further support banks' efforts to adequately measure ESG risks and integrate them within their risk processes. Data limitations should not be a rationale to defer taking immediate action. Banks can develop interim proxies, and additional ESG data can be sourced from third parties and through client questionnaires. These exercises should be supported by supervisors.

Study participants highlighted that approaches to measure exposure to ESG risks, such as stress testing and scenario analysis, should be further refined through more market collaboration and the development of dedicated methodologies. Stress testing and scenario analysis should form a core component of banks' and supervisors' ESG risk measurement, especially for climate-related risk. The number of scenarios should be increased, and scenarios should be sufficiently ambitious and granular in order to standardise approaches and enhance comparability of results. Regardless of involvement in supervisory exercises, banks should conduct internal climate scenario analysis to deepen their understanding of climate-related risks. Many stakeholders indicated that supervisors should conduct regular, mandatory climate stress tests for banks in order to assess vulnerabilities and foster capability building. In the absence of requisite data, climate stress test exercises should make use of proxy data or assumptions.

Where possible, ESG risks should be integrated in risk management frameworks through quantitative approaches. This includes the introduction of quantitative KPIs in the RAF. Stakeholders believe that, in the short term, the integration of ESG risks should be addressed through Pillar 2 processes, supported by detailed supervisory guidance. ESG risks should be treated similarly to established financial and non-financial risk types. Within ICAAP, it should be documented if ESG risks are determined to manifest through traditional risk types. Furthermore, longer time horizons associated with ESG risks should be reflected within the SREP. Developments on the EBA mandate related to a potential dedicated prudential treatment of ESG risks should be closely observed, and supervisors should analyse a potential risk differential to assess the risk relevance of a green supporting or brown penalising factor in Pillar 1 capital requirements.

The identification of portfolio related quantitative KPIs is a key requirement for furthering ESG integration into risk management and credit processes. There is broad agreement among stakeholders that supervisors should create a base of common indicators and indicative thresholds to support the quantitative assessment of ESG risks. Such metrics will facilitate the assessment of banks' ESG risk exposure and help maintain a level playing field. Additional efforts should be made to standardise ESG risk-related disclosure more broadly. This should be pursued through mandatory regulatory and legislative measures, such as the recent proposal for a Corporate Sustainability Reporting Directive (CSRD) – which would amend existing Non-Financial Reporting Directive (NFRD) reporting requirements –, as well as through stronger adherence to market initiatives. Such measures should adhere to the proportionality principle. Regulatory developments, such as those related to the EBA mandate on Pillar 3 disclosures, should be closely observed by banks and supervisors. Supervisors should additionally encourage disclosure of ESG risks ahead of the effective date, in particular for climate-related risks.

Enabling factors to integrate ESG objectives into EU banks' business strategies and investment policies

Various instruments could be considered to help address data challenges, for example defining common technical standards on banks' ESG data collection requirements via regulation. The definition and implementation of such standards could support the assessment and understanding of ESG risks in the banking sector, and hence the resilience of supervised institutions against ESG-related risks in line with prudential objectives**.** These instruments could also include mandatory reporting of ESG indicators and metrics. Legislative measures aimed at extending mandatory ESG data disclosures to smaller companies, the introduction of requirements for external validation of self-reported data, as well as standards for disclosure of ESG data similar to accounting standards could be considered in order to improve ESG data coverage, accuracy, and credibility. Beyond such instruments, banks should address their own data needs through further engagement with clients, particularly smaller corporates, including by requesting additional ESG data to improve data availability.

To harmonise ESG product classification, compliance with certain standards, such as the EU Green Bond Standard or the EU Taxonomy, could be made compulsory. This could improve the consistency of product offering observed in the market and mitigate the risk of greenwashing, supporting trust in the sustainable product offering by the banking sector. Many stakeholders highlighted that an expanded taxonomy or taxonomy-like classification system, defining brown and grey activities, as well as considerations on the social dimension, could further standardise the classification of business activities. The application of an expanded taxonomy could also increase harmonisation of disclosure of ESG activities.

Measures aimed at increasing accountability at executive and board level could be introduced. This could mean encouraging banks, including at executive and board level, to take responsibility for alignment of their ESG strategies with international agreements and initiatives, especially for the E pillar while taking into account the assessment of their ESG risks.

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