EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Andrea Enria
Chair of the Supervisory Board

Mr Bas Eickhout
Mr Ernest Urtasun
Members of the European Parliament
European Parliament
60, rue Wiertz
B-1047 Brussels

Frankfurt am Main, 23 March 2022

Re: Your letter (QZ-005/2022)

Honourable Members of the European Parliament, dear Mr Eickhout and Mr Urtasun,

Thank you for your letter on the supervision of climate-related and environmental risks, which was passed on to me by Ms Irene Tinagli, Chair of the Committee on Economic and Monetary Affairs, accompanied by a cover letter dated 17 February 2022.

You inquired about the ECB's expectations on climate-related and environmental (C&E) risks and how they will increase in the coming two years. The European Central Bank (ECB) has identified banks' exposure to C&E risks as one of the main vulnerabilities in the European banking sector since 2019. In 2020 the ECB published a guide on climate-related and environmental risks which set out its expectations on how banks should prudently manage and transparently disclose such risks under current prudential rules.[1] It also outlined its supervisory roadmap to follow up on how institutions manage C&E risks by the end of 2022.

Shortly after publication of the ECB guide on climate-related and environmental risks in early 2021, ECB Banking Supervision requested that banks conduct self-assessments of their practices in relation to these expectations and to develop implementation plans detailing how and when they would bring their practices into line with the guide. ECB Banking Supervision published a first report with its review of banks' submissions, with the aim of disclosing the level of banks' alignment with ECB Banking Supervision's expectations and to provide feedback on the main areas for improvement.[2] The review demonstrated that

1 See ECB publishes final guide on climate-related and environmental risks for banks, Press release, ECB, November 2020.

2 See The state of climate and environmental risk management in the banking sector, ECB, November 2021.

none of the institutions are anywhere near to fully aligning their practices with supervisory expectations. And, while virtually all institutions have developed implementation plans, more than half of the institutions will not have completed their plans by the end of 2022, with around one-fifth not having any short-term deliverables in place. As a follow-up to the review, ECB Banking Supervision published various examples of good practices, including how institutions are performing data gap analyses and collections with the aim of integrating C&E risks into reporting practices. A second snapshot of the level of disclosure of C&E risks by significant institutions was published in March 2022, confirming that significant gaps remain, despite the progress made since the first assessment in 2020.[3]

Requiring banks to address risks stemming from climate change and environmental degradation is also one of ECB Banking Supervision's supervisory priorities for the 2022-2024 period.[4]

To that end the 2022 SREP cycle will be marked by several key initiatives, further enhancing the supervision of C&E risks.

The first of these initiatives is the climate risk stress test, which was launched in January 2022 and is currently being conducted by a dedicated supervisory team. This stress test was designed, first and foremost, as a learning exercise – for supervisors, for banks, and for the financial industry as whole.

The second is a comprehensive review of banks' practices related to strategy, governance and risk management – the thematic review on C&E risks. The main goal of the review is to assess the evolution of the soundness, effectiveness and comprehensiveness of banks' C&E risk management practices, as well as their ability to steer their C&E risk strategies and risk profiles. As part of this thematic review, ECB Banking Supervision will also be looking more closely at the risk management practices for both climate-related and environmental risks.

As regards your second question, we are aware of current data and methodological limitations. This is why the ECB strongly welcomes the competent authorities' mandate with respect to the minimum standards and reference methodologies included in Commission's banking package proposal. At the same time, supervisors have already clarified that institutions are expected to adopt a strategic approach to managing these risks and take intermediate steps as appropriate. When C&E risks are hard to quantify, institutions are expected to determine sufficiently conservative risk estimates, taking into consideration all relevant and available information and ensuring adequacy and consistency in the application of risk quantification methodologies. More precisely, institutions should develop plausible proxies and assumptions to perform an assessment of climate-related and environmental risks where quantification methodologies are under development. Moreover, institutions should employ the full array of risk management instruments at their disposal, including qualitative approaches where appropriate. It should be noted, however, that so far only a few banks have made an inventory of their data needs for calculating C&E risks.

Meanwhile, ECB Banking Supervision is further building up the relevant capacities of its supervisory teams and will start treating these risks just like any others. For example, the thematic review will be fully embedded in the work of every Joint Supervisory Team. In 2022 the observations of the thematic review and of the

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3 See Supervisory assessment of institutions' climate related and environmental risks disclosures, ECB, March 2022.

4 See ECB Banking Supervision: SSM Supervisory Priorities for 2022-2024, ECB, January 2022.

climate stress test will also be qualitatively integrated into the SREP scores for the first time, which may have an indirect impact on capital requirements. Targeted qualitative requirements may also be imposed. As part of the review, we will also carefully check whether banks have followed up on any requirements we issued last year. The thematic review is a full-on supervisory review, and ECB Banking Supervision will make use of the full set of supervisory tools at its disposal.

ECB Banking Supervision's main objective is to contribute to the safety and soundness of the banking system and to the stability of the financial system. Supervision is risk-based and forward-looking, and assesses banks on an individual level.[5] However, the ECB also analyses the overall resilience of the financial system within its financial stability tasks. In this vein, work is ongoing to fully understand the financial stability implications of climate risks and mitigation policies (including transition plans) and how they could feed back into the real economy, ultimately affecting the climate transition itself.

Yours sincerely,

[signed]

Andrea Enria

5 See Towards an immersive supervisory approach to the management of climate-related and environmental risks in the banking sector, ECB, February 2022.