CASE STUDY 2

INTRODUCTION:

In the face of society's growing ecological awareness and ongoing climate change, the company faces the challenge of adapting to new standards of risk management related to environmental, social and governance (ESG) issues.

In this context, European supervisors, including the European Banking Authority (EBA) and the European Central Bank (ECB), are defining action plans and good practices for banks' ESG risk management. This case study will focus on analyzing the actions taken in the enterprise in response to the EBA and ECB guidelines.

REGULATORY CONTEXT:

In December 2022, the EBA published plans for ESG risk management in banks, covering 8 areas in which banks will have to adapt to the new guidelines.

These actions include issuing ESG risk management guidelines in 2024 and conducting climate stress tests. At the same time, the ECB conducts reviews of banks in terms of ESG risk management and conducts climate stress tests, which require banks to adapt to the new standards by the end of 2024.
By looking at the indicated areas, you can try to define key areas and it is also important for the enterprise in relation to ESG reporting guidelines, you should be aware of activities and challenges in the topic.

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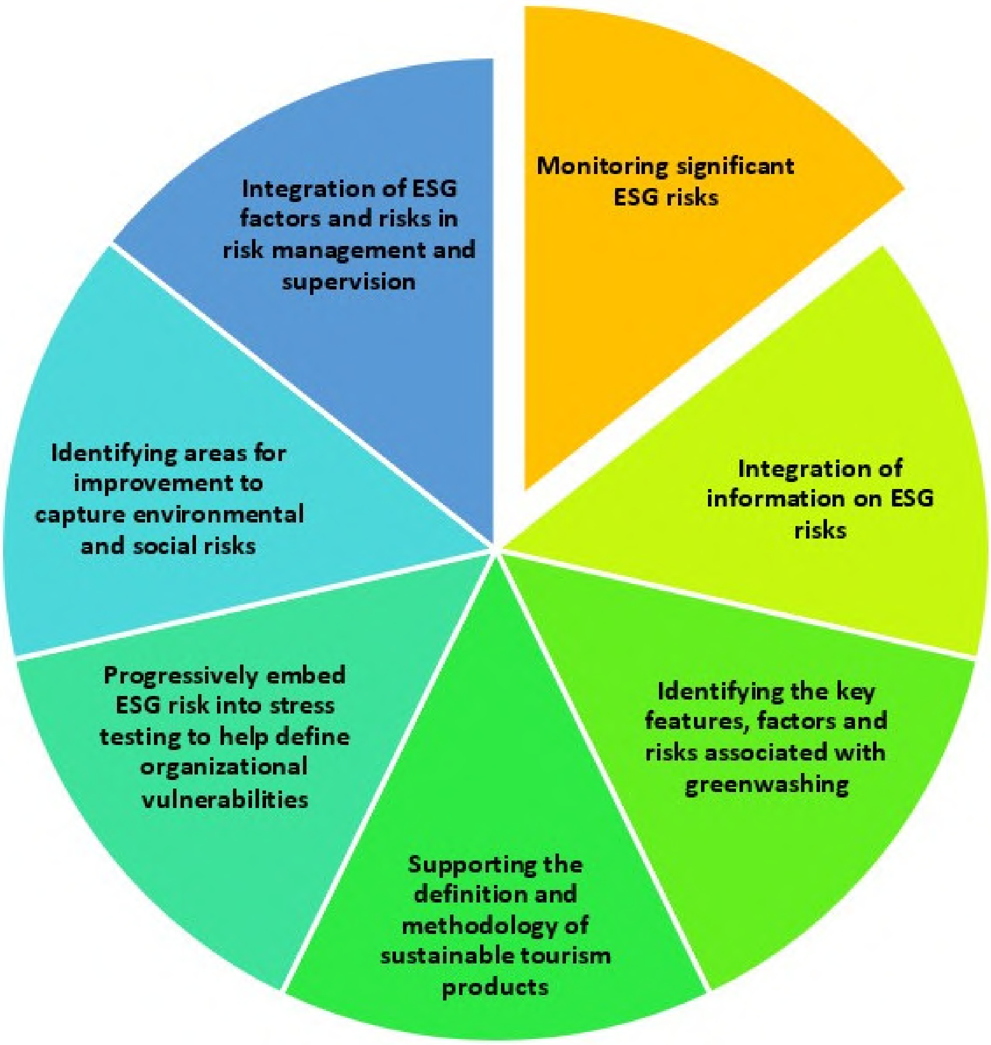
SPECIFIC AREAS regarding the directions of changes in sustainable development from the perspective of the organization based on the Deloitte report.



ANALYSIS OF BANKS' EXPERIENCE IN THE FINANCIAL SECTOR:

European banks, subject to climate reviews and stress tests, experience significant workload in adapting to the expectations of the EBA and ECB. These reviews show that most institutions have at least basic practices in place to manage environmental risk, but there are some gaps, particularly in methodology and the effective implementation of practices.

Based on ECB reports, banks must accelerate work on the comprehensive implementation of environmental risk management guidelines, especially taking into account the planned climate stress tests in 2024 and EBA guidelines.

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. The ECB emphasizes the need to assess the materiality of risks, adapt business strategy to climate-related issues, and effectively manage risks in the context of assessing economic capital.

Some sectors of the economy have more time, but by observing activities in the area of ESG and ESG risk management in other sectors, as many conclusions as possible should be drawn to implement new guidelines and new regulations for the entire sector. Being aware of the burden placed on management staff by new guidelines, it is necessary to look at good practices in other industries in this area. Also remembering that the duration of implementation is influenced by the fact that the ESG area is constantly developing and supervisors may be less understanding towards immature processes, which have so far been explained by the lack of developed market practices and available solutions.

GOOD PRACTICES AND ACTION PLAN:

In November 2020, the European Central Bank (ECB) published its "Climate and Environmental Risk Guide", setting out expectations for the banking sector in managing ESG risks. In 2022, a review of 186 European banks was conducted, revealing that more than 85% had at least basic environmental and climate risk management practices in place. However, shortcomings regarding methodology, the use of risk information and active portfolio management remain apparent.

The ECB expressed serious concerns about banks' ability to effectively implement environmental and climate risk aspects into existing processes.

Even though 55% of institutions have developed appropriate practices, their effective implementation remains problematic. These shortcomings result mainly from the inappropriate addressing of the materiality of risks, the lack of allocation of key indicators to business lines and the lack of clear corrective actions.
To meet supervisory expectations by 2024, banks must adapt to all requirements, including the implementation of new supervisory instruments. The review covered four areas: materiality assessment, business strategy, corporate governance with risk appetite and risk management.

In the area of risk management, almost all institutions have basic methods in place to quantify climate risk, but most have not yet developed detailed methods to understand future risk. These conclusions indicate that banks need to take action to comply with supervisory expectations.

The ECB identifies 26 good practices from 25 different financial institutions that may guide future changes in banks' internal processes. Key aspects include assessing the materiality of environmental and climate risks, including environmental risks in ICAAP, and effective climate stress tests.

SECTION	SUB-SECTION	GOOD PRACTICES
Materiality	Identification of risk drivers	1. Mapping out risk drivers to identify transmission channels
	Identification of exposures	2. Risk assessment methods to assess materiality of exposures
	Determination of materiality	3. Setting materiality thresholds and follow-up actions
Business strategy	Strategic approaches	4. Managing risk via transition planning (transition planning) 5. Scenario choices for goal setting (setting medium and long-term goals using tools prospective) 6. Use of financing products and services (transition)
	Strategic steering tools	7. Maintaining and exiting client relationships 8. Assessing the maturity of client transition plans
Governance and risk appetite	Management body	9. Steering on business strategy and net-zero commitments
	Remuneration	10. Aligning remuneration policies with climate-related objectives
	Organisational structure	11. Climate-related risks and the second line of defence 12. Embedding C&E risks into internal audit reviews

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SECTION	SUB-SECTION	GOOD PRACTICES
Governance and risk appetite	Risk appetite	13. Pointing forward with key risk indicators
	Reporting	14. Governance, processes and collection of C&E-related risk data 15. Internal reporting on climate-related risks
Risk management	Due diligence	16. Data-driven due diligence of (new) clients 17. Assessing clients for potentially controversial activities
	Risk classification	18. Credit risk: Classifying debtors via a scorecard and/or integration in PD-rating systems 19. Market risk: Classifying exposures to transition risk in the trading portfolio 20. Operational risk: Assessing physical risks to the business continuity of operations
	Collateral valuations and pricing	21. Integrating C&E risks in loan pricing frameworks 22. Reflecting C&E risks in the valuation and management of collateral
	ICAAP	23. Allocating economic capital for material C&E risks
	Environmental risks	24. Excluding clients conducting activities with adverse environmental impact 25. Addressing environmental risks in client due diligence 26. Portfolio foot-printing to assess impact on biodiversity

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Source: Raport EBC, Good practices for climate related and environmental risk management. Observations from the 2022 thematic review, (https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.thematicreviewcercompendiumgoodpractices112022~b474fb8ed0.en.pdf)

Key risk management recommendations that may be extremely important for building the ESG risk management process:

1. Banks should develop an action plan including:
   - Review of previous activities in terms of good practices identified by the ECB.
   - Identification of areas requiring adjustment.
   - Implementation of changes to internal processes, especially those related to materiality assessment, business strategy and risk management.
   - Preparation for climate stress tests, including obtaining data on greenhouse gas emissions, energy efficiency certificates, etc.

2. Banks should develop an action plan including:
   - Review of previous activities in terms of good practices identified by the ECB. Identification of areas requiring adjustment. Implementation of changes to internal processes, especially those related to materiality assessment, business strategy and risk management.
   - Preparation for climate stress tests, including obtaining data on greenhouse gas emissions, energy efficiency certificates, etc.

SUMMARY:

Companies must adapt to ESG regulations introduced by the EBA and ECB. Adopting good practices from the financial sector and focusing on key areas such as risk materiality assessment, business strategy and effective climate stress tests will help enterprises manage ESG risk and adapt to new regulatory standards. The implementation of changes should be carried out systematically, in accordance with the action plan, and take into account the individual characteristics and challenges of each enterprise.

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QUESTIONS FOR THE PARTICIPANT:

1. **Does** your organization manage environmental risk? What tools have been implemented to identify ESG risks in the organization?
2. **What** methods of qualitative and quantitative ESG risk analysis have been used in your organization?
3. **Does** your company have an action plan that includes a review of current practices and identification of areas requiring support and modification in the context of ESG risk management?

Material based on a Deloitte article
https://www2.deloitte.com/pl/pl/pages/financial-services/articles/ryzyka-ESG.html