



The challenges of good corporate citizenship



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ABSTRACT

This article is based on the key-note speech given by Andrea Enria, Chair of the Supervisory Board of the European Central Bank, at Febelfin Connect (Brussels, 28 March 2022), Febelfin's annual networking event. The topic of this year's event was "*Financing the transition towards a more sustainable society*".

Søren Kierkegaard said that "*life can only be understood backwards; but it must be lived forwards.*" Looking back, there were ominous signs that this unthinkable war of aggression would break out on our continent. Now, we all must contend with this reality.

In my remarks today, I will focus largely on banks' management of climate-related and environmental risks. But I will start with the gravest challenge facing banks today as corporate citizens.

Confronted with the most serious geopolitical crisis in Europe since the Second World War, many firms have been very conscious of how their reactions reflect on them as corporate citizens. Several multinational corporations have suspended their operations in Russia and buyers are shunning Russian oil in favour of European Brent crude. This could be because companies do not want to remain neutral in the face of moral crisis. But they might also be anticipating consumer reactions. In our market economy, values in the form of consumer preferences can affect a company's bottom line. The starker the moral choice, the more willing consumers might be to prioritise their moral values above other factors, like convenience or price, when choosing a service or product. Similarly, investors' reaction to perceived corporate misbehaviour could impose steep losses on shareholders and seriously dent the corporate image. It is in the company's interests to respond to or even anticipate this feedback and adjust its course. Most importantly, as the internationally coordinated response to the war centred on financial sanctions, corporations in general, and banks in particular, need to make sure that they have strong internal processes and controls to avoid any breach of the sanctions regime. We know from experience that the reputational and financial damage from breaching



international sanctions could be massive. And this time it would be even more severe, in light of the strong emotional impact generated by the scale of the humanitarian crisis in Ukraine.

Navigating this situation is obviously challenging for banks. The frameworks for dealing with social (and governance) risks, under which such a situation might be subsumed, are not very developed yet. ^[1] There is certainly no one-size-fits-all answer, just as managing climate risk does not entail immediately divesting all carbon-related assets. But banks must be aware that actions which might amount to financing an illegal war condemned by the international community, or willingly profiting from breaches of international sanctions, run totally counter to good corporate citizenship. In addition to governments and supervisors, consumers and investors will also have a say in this.

Kierkegaard's insight on only understanding life backwards, but having to live it forwards, applies equally to man-made climate change. Looking back, we clearly see that the burning of fossil fuels has caused our atmosphere to trap more heat, with devastating consequences we have chosen to ignore for too long. But this recognition offers no immediate solution as to how we can stop using fossil fuels: the direction of travel is clear, but the speed and trajectory of the transition is hostage to developments that are extremely difficult to predict. The far-reaching repercussions of the war in Ukraine on energy markets will surely lead to a significant reconsideration of energy policies, and while we can assume that the overall effect will be an accelerated transition, the contours of the path ahead remain shrouded in fog.

Wholesale change is required to transition to a carbon-neutral economy. With banks' balance sheets mirroring the real economy, they will be affected accordingly. Banks face both the physical risks of damage to assets through climate change, and the transition risks of carbon-intensive assets losing value. Climate-related and environmental risks, C&E risks for short, are therefore one of the ECB's supervisory priorities for 2022-24. The first time I mentioned climate-related risks as a focus for ECB Banking Supervision was in June 2020, not even two years ago. Since then, there has been considerable supervisory action. In 2020 we published our Guide on climate-related and environmental risks^[2], which outlined our supervisory expectations for the management and disclosure of these risks. In 2021 we followed this up with a supervisory review of banks' approaches to managing these risks based on their own assessments – the results of which we shared with the industry and the public. And this year we launched the climate risk stress test. We also published a report on the transparency of banks' disclosures of their C&E risk profiles and a thematic review of how banks incorporate C&E risks into their processes. The latter is a fully fledged supervisory exercise which involves the teams responsible for the day-to-day supervision of banks.

The challenge of adequate C&E risk disclosure

Two weeks ago we published our assessment of banks' C&E risk disclosures.^[3] This is the second time we have conducted such an analysis. It is therefore becoming a regular exercise, reflecting our strong view that transparency must be the basis for dealing with any financial risk effectively.

Banks need meaningful and accurate information about their risks to be able to manage them, and the disclosure of this information allows investors to make sounder decisions. This, in turn, improves market



discipline and makes the supervisor's job easier as well. By providing an incentive to prudently manage C&E risks, transparency contributes to strengthening the stability of the financial system as a whole. In short, everybody stands to gain from improved transparency and better disclosures. Yet it is also true that private initiative on its own is unlikely to provide the required level of information. We need standards to allow for comparability, but the complexity of the measurement issues, diverging interests and free-riding problems usually mar the ability of private efforts to develop reliable industry standards.

Last week the US Securities and Exchange Commission proposed rules on enhancing and standardising climate-related disclosures.^[4] They pointed out that “the form and content of the disclosures may vary significantly from company to company, or from period to period for the same company. The situation resulting from these multiple voluntary frameworks has failed to produce the consistent, comparable, and reliable information that investors need.” So far, the efforts of private parties have not produced the public good that is C&E disclosure standards. This is why ECB Banking Supervision has been making a concerted push for adequate disclosures of C&E risks, too.

Compared with our first stocktake of C&E disclosures in 2020, we have seen progress, especially in the areas of risk management, governance and business models. But banks are still a long way off where they need to be. As of 2021, seven in ten banks disclosed information about C&E risk management and governance, compared to five in ten in 2020. Only four in ten shared relevant information about the incorporation of C&E risks into their strategic considerations – up from three in ten. None of the banks under our direct supervision have fully met our supervisory expectations for disclosures in either of these areas, and only 12% of them have disclosed any assessments at all on how they intend to align their portfolios with the Paris Agreement. But even when banks do report on their commitment to portfolio alignment, only around one in five provide the necessary level of detail. This involves disclosing the methodologies, definitions and criteria for all of the figures, metrics and targets reported as material. More than one-third of institutions do not disclose these aspects at all.

Banks seem to be emitting a lot of vague information about green topics to obscure the insufficient quality of their disclosures – so far, there has been plenty of noise and very little substance, as pointed out by Frank Elderson two weeks ago^[5]. Five years after the Financial Stability Board's Task Force on Climate-related Financial Disclosures published its recommendations, banks need to step up their game. By now, they can draw on a sizeable volume of high-quality climate-related data, tools and information shared by different international and European organisations and institutions in recent years. Banks know that failing to adequately disclose C&E risks amounts to a breach of the Capital Requirements Regulation, just as with any other risk, and with all the consequences this can entail. We will not hesitate to use the tools at our disposal to ensure that banks under our supervision sufficiently disclose the climate-related and environmental risks they are exposed to.

The thematic review, stress test and the “capital question”

Identifying C&E risks is necessary for managing them, but it is obviously not sufficient. We are therefore following up on our initial supervisory assessment of the banks' management of these risks with our thematic



review. How sound, effective and comprehensive are banks' climate-related and environmental risk management practices, and how well are they able to steer their C&E risk strategies and risk profiles?

In last year's Supervisory Review and Evaluation Process, or SREP, we identified the gap between each bank's practices and our supervisory expectations. We issued a relatively large number of qualitative recommendations aimed at addressing the shortcomings identified. This year we will monitor the progress in closing that gap and gradually step up the supervisory pressure on those banks lagging behind the industry's best practices. We intend to make the review of C&E risks a standard, integral part of the SREP. As soon as the regulatory framework is completed, we will adjust our supervisory practices to the legislative requirements and to the EBA Guidelines.

This year we also launched a far-reaching, bottom-up climate stress test. We made clear from the outset that this is a learning exercise, for both banks and supervisors. It will provide a better understanding of the ability of banks to measure physical and transition risks, also under stressed conditions. It will also enable the ECB to benchmark banks against their peers, in terms of stress testing capabilities, sustainability of their business model and their exposures to carbon-intensive companies. Also, in this case, the results will be reflected in recommendations to address relevant shortcomings in our SREP process.

Another important element of the C&E supervisory puzzle will be focused on the banks' own transition plans. According to legislative proposals put forward by the European Commission, financial institutions will be required to set out their path towards carbon neutrality. We as supervisors will be in charge of vetting both the plans and the ability of the banks to respect their own commitments.

Whenever we present this comprehensive set of supervisory tools aimed at fostering progress in this area, we are also confronted with the "capital question". When will we start charging capital for C&E risks? How will the capital charges be calculated? These questions imply that it's simply a case of coming up with an algorithm that links climate risk exposures to basis points of capital requirements. I find all this a bit frustrating. It conveys the impression that banks would be moving in the direction indicated by their supervisors and properly capture relevant risks only if threatened with the big capital stick. But it is clearly in the interests of the banks, before and even more so than in the interests of the community they serve, to take prompt action in this area. Physical and transition risks are of a magnitude that could endanger the continued operation of a bank, if they are not properly managed. According to estimates published by the ECB^[6], the probabilities of default of bank counterparts could rise to 30% for the banks most exposed to climate risks in a "hot house" world. These risks should not be factored in just out of fear of capital action by the supervisor, or external pressure from consumers and investors.

In any case, I think we have been clear in consistently explaining that the exercises we are running this year – both the thematic review and the stress test – have not been designed with the objective to raise capital charges. The main outcome will be reflected in qualitative recommendations, even though all the information collected will be used by our supervisory teams, and it might well be the case that serious shortcomings identified in governance or risk management practices may affect the banks' scores, and therefore indirectly have a quantitative effect on Pillar 2 requirements. Of course, as in any other area of our SREP process,



qualitative recommendations matter as well. If the shortcomings they target are not addressed in a reasonable timeframe, successive SREP cycles will follow an escalation process, and capital charges will naturally be part of our toolbox. The same escalation process will apply in the future if banks are incapable of respecting the transition plans. In a nutshell, C&E risks will become an integral part of our SREP process and affect all the modules of our supervisory analysis.

Banks in the banking union are not yet where we want them to be, with regard to both the disclosure and the management of their C&E risks. Relative to their global peers, however, they seem to have a head start. European significant institutions are clustered around the top of Autonomous Research's Paris Readiness Index^[7], for example. The authors of that report attribute this placement not least to the regulatory and supervisory demands placed on European banks.

Often, these demands are portrayed by banks as putting them at a competitive disadvantage. Market analysts, however, contend that the opposite is true.^[8] By looking at various estimates of the market potential for green and non-green finance from institutions like the UN Environment Programme, OECD, International Energy Agency and others, they find that rather than being a zero-sum game, the demand for green investments vastly outstrips the diminishing financing needs of non-green investments. The average estimate of additional financing opportunities for global banks from the green transition amounts to \$2.3 trillion per year. This could translate into almost €6 billion in additional annual revenue for listed European banks. Banks that lead on C&E risks will not only boost environmental sustainability, but also the sustainability of their business models.

The balance sheet choices banks will make about green and non-green assets will materially impact their bottom lines. And the direct impact may be compounded by how these choices reflect on banks as corporate citizens. A C&E transition risk for banks is traditionally defined as the risk that non-green assets will lose value, either because of government action or consumer choices. But there is a transition risk in a broader sense: consumers and investors will move away from banks if they disagree with their approach towards climate change and environmental challenges. As I pointed out: values, expressed as consumer and investor preferences, can affect a company's earnings and valuations, and banks are no exception.

Conclusion

Søren Kierkegaard also said that *"our life always expresses the result of our dominant thoughts."* I am therefore confident that by making C&E risks a supervisory priority, their effective management will be the end result. I am equally confident that banks will stand to benefit from the green transition. And with banks facing the greatest geopolitical crisis in Europe since the Second World War, now more than ever we should remember: good corporate citizens contribute not only to society's sustainability, but to their own sustainability as well.

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