

ESG RISKS MANAGEMENT AND SUPERVISION

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What are ESG risks and why are they important?

Environmental, social and governance (ESG) matters may have a positive or negative impact on households, corporates and financial institutions. Notably, scientific evidence ⁽¹⁾ suggests that climate change and environmental degradation, and the associated need to transition towards an environmentally sustainable economy, will lead to changes in the real economy that will in turn impact the financial sector through new risks and opportunities. Environmental risks include the physical impact of global warming which may make some geographies higher risk, and transition risks as public policy, technological advancements and market sentiment may lead to some activities being phased out. Social risks include the negative financial impacts linked to factors such as inequality, health or labour relations, whereas governance risks include the negative financial impacts linked to factors such as executive leadership or bribery and corruption.

Banks and investment firms can be impacted by ESG risks through their core business activities, i.e. through their lending and investing activities: the financial risks stemming from the current or prospective impacts of ESG factors on their counterparties or invested assets. For example, counterparties can be affected by the physical effects of climate change, such as floods impacting properties, or by policy, technology or market changes, such as consumers' preferences for sustainable products that arise as we move towards a more sustainable economy. In addition, banks and investment firms also have an impact on the environment and society through their lending and investments (the 'double-materiality' of ESG risks).

Because of their scale, breadth, and complexity, ESG risks can impact the financial system and economy as a whole, with potential systemic consequences.

Institutions need to build their resilience to ESG risks across different time horizons, by taking a comprehensive and forward-looking view, as well as early and proactive actions, under supervisory scrutiny.

⁽¹⁾ See e.g. reports from the Intergovernmental Panel on Climate Change (IPCC) e.g. IPCC (2018), 'Global Warming of 1.5°C - Summary for Policymakers'

What is the EBA's role?

The EBA is assessing and recommending how to best include ESG risks into the banking regulatory and supervisory framework, with an emphasis on climate and environmental risks in the first stage although social and governance risks are already important and necessitate attention.

Building on its participation in international and European fora, the EBA provides common definitions of ESG risks, describes their transmission channels and lays out recommendations on incorporating these risks into disclosures, risk management and supervision. ESG disclosures will be key in allowing stakeholders to assess banks' environmental risks and their sustainable finance strategy ^[2].

The EBA provides institutions with supervisory expectations on how to build a resilient business model and risk management system to ensure their preparedness for ESG-related challenges. Incorporating ESG risks-related considerations in strategies and objectives, integrating ESG risks in governance structures, and managing these risks as drivers of financial risks are among the actions expected from institutions. These actions will be increasingly reflected in the regulatory framework. Furthermore, the EBA will include ESG risks in its guidance on the supervisory review and evaluation process performed by EU supervisors.

The EBA also sees a need to pursue work and test new methods, such as scenario analyses, to assess the resilience of institutions to ESG risks, in order to improve understanding on the robustness of their business model and investment strategies ^[3]. Both institutions and supervisors should develop methodologies to assess the future possible impacts of ESG risks.

^[2] The EBA is developing standards in this area [\[ESG disclosures factsheet\]](#).

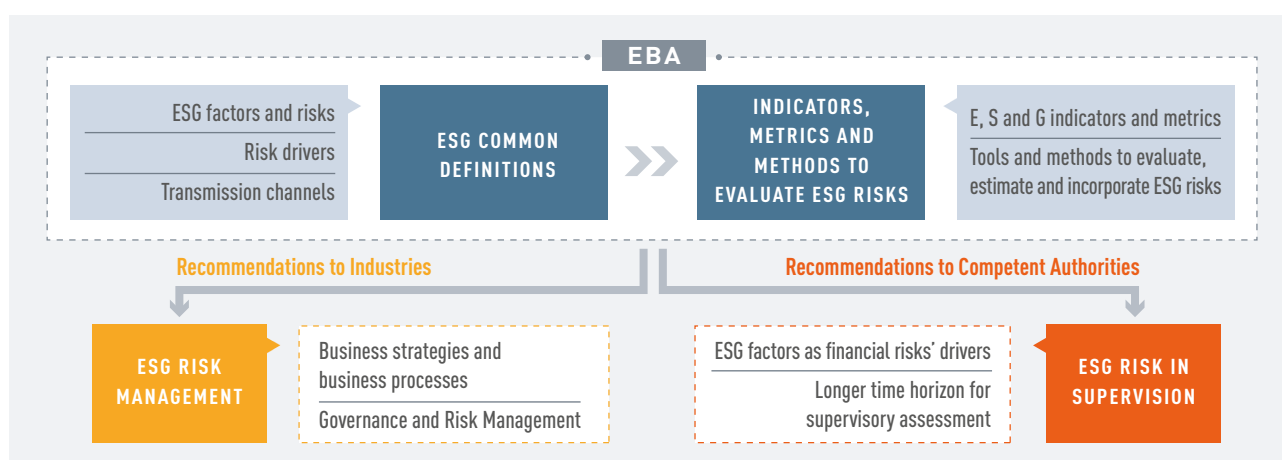
^[3] See [EBA pilot exercise](#) on climate risk mapping banks' exposures to climate risk and providing an insight into the green estimation efforts banks have carried out so far.

WHY SHOULD INSTITUTIONS AND SUPERVISORS TAKE ACTION NOW?

The needed transition towards a more sustainable economy will spur new business opportunities but will also expose financial institutions to risks stemming from the transition. At the same time, financial institutions' assets will be exposed to changing physical conditions.

Although these risks are likely to fully materialise over the long-term, action is needed now to identify what institutions' and supervisors' responses should be and to progressively start implementing the necessary steps. Given the potential of ESG risks to fundamentally change the way EU economies work, a strategic approach must be taken.

The actions taken by the EBA to support the full incorporation of ESG risks by institutions and supervisors aim to safeguard the resilience of the financial sector in the short-, medium- and long-term and ensure that banks and investment firms are well-equipped and -positioned to effectively address ESG risks and to support the sustainability transition.



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