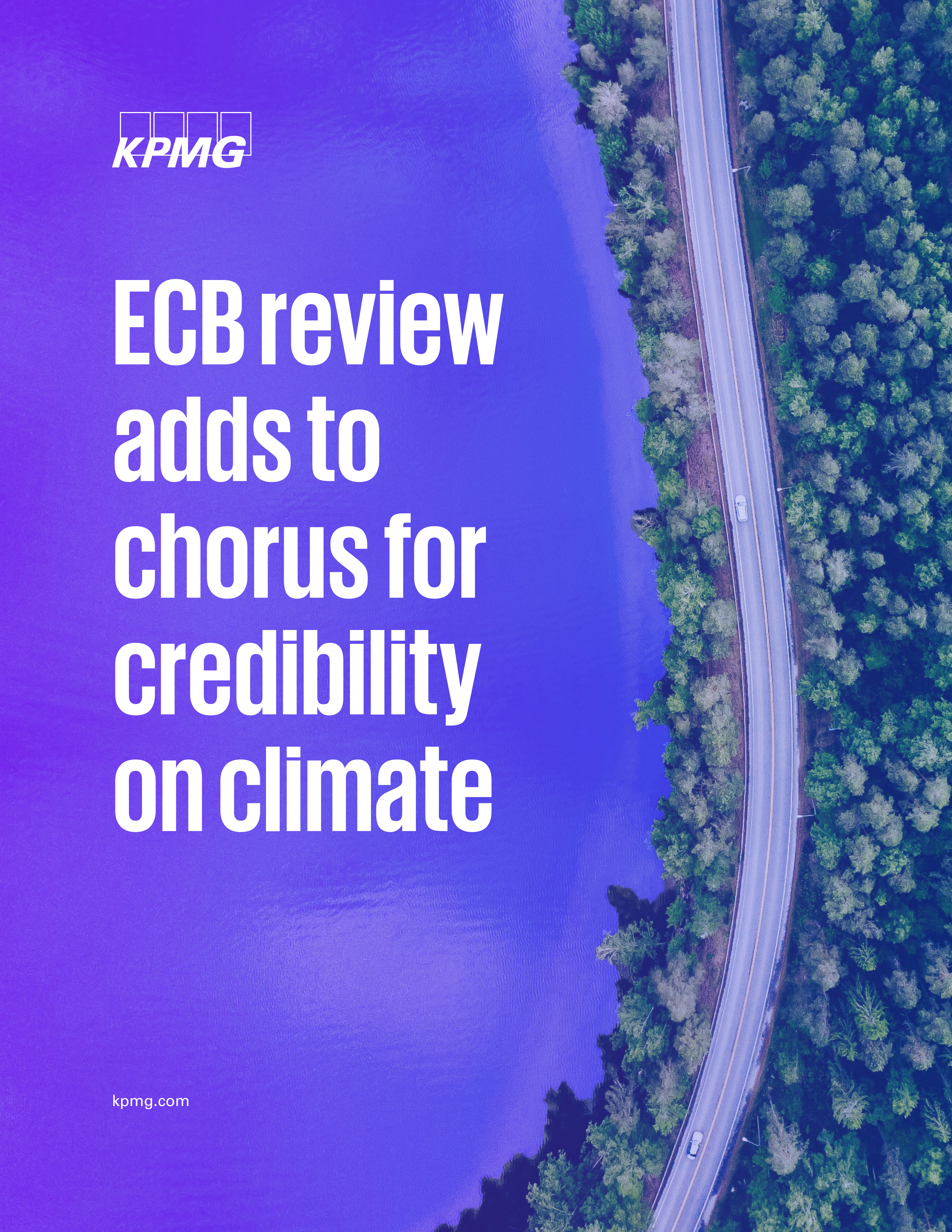

# ECB review adds to chorus for credibility on climate

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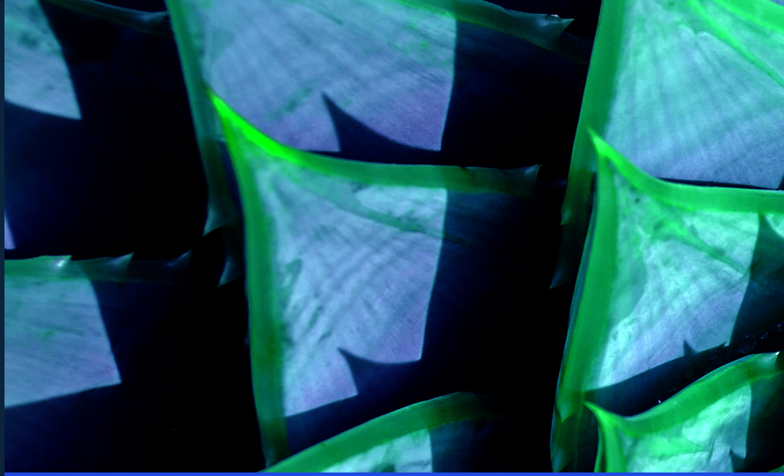
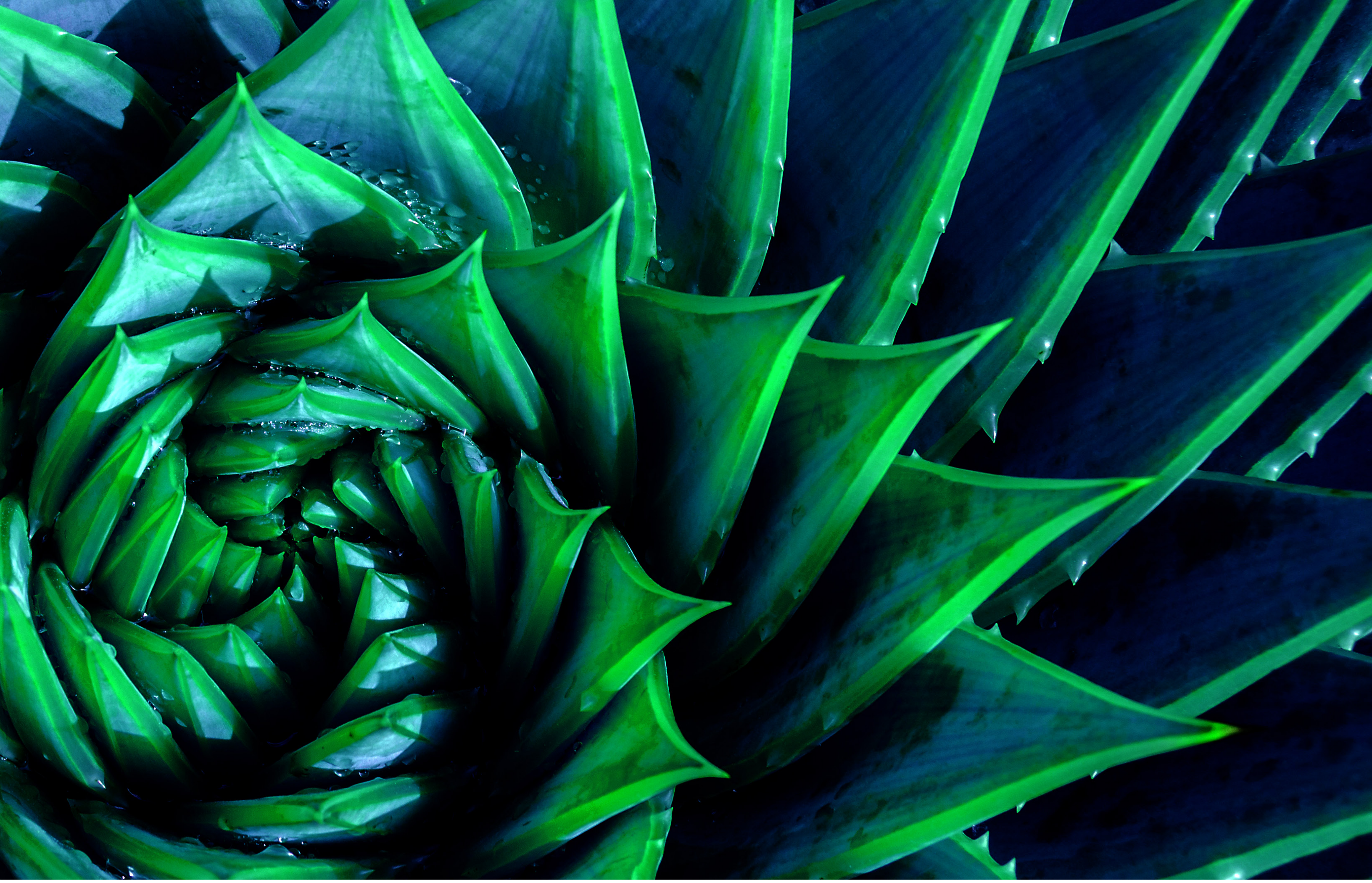


## In November 2022, the European Central Bank (ECB) released the results of its 2022 thematic review[1] of 186 European banks' alignment with the ECB's 2020 guidance on climate-related and environmental-related financial risks.[2] While the ECB found improvements over its first survey in 2021, it also discovered significant gaps.

For example, while over 90 percent of banks surveyed had conducted a basic materiality assessment[3], nearly all (96 percent) had blind spots, 60 percent of which the ECB considered to be major gaps. Unsurprisingly, concerns in materiality assessments had downstream impacts that contributed to additional concerns related to governance, risk appetite, and strategy. The ECB also found that firms were farther along in climate-related financial risks, rather than environmental-related financial risks.

**While this survey focused on European banks, U.S. financial organizations like yours should also review ECB examiner observations closely:**

- The report continues the drumbeat from investors and regulators for increased credibility of disclosure and underlying risk management related to climate and environmental risk management. The ECB went as far as including the phrase "walking the talk" in the title of the thematic review. Since the release of the ECB report, the European Banking Authority (EBA) has released its three-year roadmap, which includes these priorities: transparency; integrating environmental, social, and governance into risk management frameworks; and addressing greenwashing risks.[4]
- The U.S. Financial Stability Oversight Council, an organization that coordinates the actions of U.S. financial services regulators, has recommended that U.S. banking regulators coordinate with international regulators on their climate risk efforts.[5] As the ECB is moving earlier than U.S. regulators in some ways, it is likely that ECB observations will inform how U.S. supervisors review U.S. financial organizations. The general tone of the ECB 2020 guidance—with its focus on integrating climate risk into standard risk management practices—is also consistent with draft guidance from U.S. banking regulators.[6]
- As of this publication date, U.S. regulatory surveys on climate risk are either underway or the results are not public.[7] The ECB's observations may be instructive to your financial organization on how U.S. regulators perceive these issues.



We summarized the most significant takeaways of the ECB survey for U.S. financial and foreign banking organizations with a lens on how chief risk officers (CROs) or climate teams can address them.

## Key observations from ECB examiners and what to do now

| Topic | Materiality assessment |
|---|---|
| **Significant gaps** | 1. Many firms surveyed did not consider their main business lines or geographies where they are active (in some instances, because they were "piloting" such assessments in particular business lines).<br>2. Many firms used a narrower scope of physical and transition risk assessment than recommended in ECB guidance, e.g.,:<br>a. Physical risk assessments were focused on the impact of drought and flood on credit risk and did not consider other drivers noted by the ECB, i.e., storms/hurricanes and water stress.<br>b. Transition risk assessments mainly focused on policy/regulation impact and less on other drivers noted by the ECB, such as technology or market sentiment.<br>3. Two-thirds of banks surveyed did not consider short-and long-term credit risk.<br>4. Firms surveyed often used qualitative approaches. However, firms that used quantitative approaches were more able to gauge materiality. |

| Topic | Materiality assessment |
|---|---|
| Takeaways for financial organizations and how KPMG can help | **Takeaway for climate, environmental risk, sustainability leaders and/or CROs:**<br>1. Confirm materiality assessments:<br>a. Consider all material geographies and business lines<br>b. Consider all drivers listed by the ECB for physical and transition risk assessments<br>2. Advance materiality assessments through developing plans for execution:<br>a. Longer-term time horizons<br>b. Quantitative approaches<br><br>**How KPMG can help**<br>1. Develop materiality assessments of climate- and environmental-related financial risk consistent with the ECB and EBA expectations and U.S. expectations on materiality, including drafting or reviewing related policies and procedures as needed.<br>2. Challenge materiality assessments.<br>3. Assist firms and confirm comprehensiveness of materiality assessments.<br>4. Assist firms and use results of materiality assessments to build or strengthen climate risk management programs.[8] |

| Topic | Strategy |
|---|---|
| Significant gaps | 1. Many firms surveyed focused on monitoring the impact of climate change and/or environmental degradation on their business, but were unaware of risks that could endanger the resilience of their business model.<br>2. For 90 percent of firms surveyed, the ECB found that institutions' strategies do not respond to their exposure to ongoing material risk:<br>a. Leading firms are using scientific pathways in strategy-setting, typically using portfolio alignment methodologies. This could lead to requirements for clients to implement time-bound action plans or alternative risk classification or pricing procedures.<br>b. Some firms use scenario analysis to test the adequacy of various strategic responses.<br>3. Firms often considered expert judgments that did not include longer-term horizons or impacts at the business area lines. |

| Topic | Strategy |
| --- | --- |
| Takeaways for financial organizations and how KPMG can help | **Takeaway for climate, environmental risk, sustainability leaders, and/or CROs:**<br>1. Confirm that your business model is resilient to climate and environmental degradation—and not just the impact of climate—in your assessment.<br>2. Begin understanding the portfolio-level impact of strategies to inform how day-to-day business activities can move portfolio pathways to optimal strategies.<br><br>**How KPMG can help**<br>1. KPMG can review or revise your climate risk management program to confirm processes exist, as well as integrate results of materiality assessments into risk management, client management, and long-term strategic planning.<br>2. KPMG has strong practices to understand both your firm's financed emissions and the extent of potential stranded assets, both of which can be used to identify ongoing strategic risks associated with climate.[9] |

| Topic | Governance, risk appetite |
| --- | --- |
| Significant gaps | In general, for firms surveyed:<br>1. Governance, risk appetite, and reporting frameworks did not cover all areas of material risk. There were frequent disconnects between an institution's materiality assessments and their governance. On a positive note, many ECB-surveyed firms have roles and responsibilities for management bodies (50 percent) and first and second lines of defense (40 percent). They have also laid the groundwork for data collection.<br>2. While some firms surveyed (25 percent) have renumeration tied to climate targets that are largely related to product goals or putting in place climate policies, not all were risk-based, i.e., tracking performance against portfolio alignment methodology. Additionally, these institutions' policies generally did not include all the functions relevant to climate in strategy-setting discussions.<br>3. Additionally, one fifth of firms surveyed acknowledged that board-approved action plans had not been completed. |

| Topic | Governance, risk appetite |
|---|---|
| Takeaways for financial organizations and how KPMG can help | **Takeaway for climate, environmental risk, sustainability leaders, and/or CROs:**<br>1. Assess the comprehensiveness of governance, risk appetite and reporting.<br>2. Develop management roles and responsibilities to include all functions relevant to climate and environmental risks in strategy setting.<br>3. Develop renumeration policy related to climate targets. Confirm other renumeration policies are consistent (i.e., a climate target goal is not canceled out by broader renumeration goals).<br>4. Treat Board-approved action plans on climate and environment like any other Board-approved action plan and make sure they are completed.<br><br>**How KPMG can help**<br>KPMG can assist organizations to conduct thorough review of their governance, risk appetite, and reporting and help them implement its findings, including:<br>1. Assisting with development of roles and responsibilities.<br>2. Assisting with development of working groups and committees that can provide information for strategy-setting, implementation plans, and reporting.<br>3. Assessing renumeration policies.<br>4. Developing tracking mechanisms to confirm that Board-approved action plans are implemented. |

| Topic | Policies, procedures, key risk indicators (KRIs), key performance indicators (KPIs), and their management |
|---|---|
| Significant gaps | 1. Over half (55 percent) of firms surveyed devised climate practices but did not implement them effectively. More specifically, these firms declared relevant counterparties to be out of scope, did not reflect available information in credit decisions, or simply did not implement the policies and procedures for significant parts of the portfolio.<br>2. KPIs are at initial stages of development:<br>a. While large goals (e.g., net zero) are in place, intermediate goals may not be in place.<br>b. KPIs generally do not cascade to individual business lines and portfolios.<br>c. No institution surveyed has taken a bankwide approach to cascading KRIs.<br>d. Institutions without granular KRIs often use qualitative measures and focus on exposures to sectors with elevated climate-related risks.<br>3. KPI management:<br>a. Only about 14 percent of firms surveyed require corrective action when KPIs are breached.<br>b. Management bodies typically receive some information with an initial set of KRIs. However, management bodies are not in a place to effectively manage climate-related risk, as monitoring and reporting is mostly done without granular and forward-looking information. |

| Topic | Policies, procedures, key risk indicators (KRIs), key performance indicators (KPIs), and their management |
|---|---|
| Takeaways for financial organizations and how KPMG can help | **Takeaway for climate staff and/or CROs:**<br>1. Treat climate and environmental policies and procedures like any others and make plans to fully implement them.<br>2. Don't let lack of KRIs stop you. Begin by focusing on sectors with known climate-related and environmental-related risks.<br>3. Develop a framework for KRIs that allows for future cascading to business lines.<br>4. Confirm that KRI and KPI breaches drive reporting and action.<br>5. Develop approach for ongoing monitoring and managing of climate and environmental risks in a forward-looking manner.<br>6. Develop intermediate targets to longer-term goals, like net zero.<br><br>**How KPMG can help**<br>Thoroughly assess the identification, assessment, and enforcement of climate and environmental risk programs to determine their level of credibility for investors, regulators, and other third parties.<br>Develop roadmaps and action plans to remediate any identified weaknesses. |

## Footnotes

[1] European Central Bank, Walking the Talk: Banks Gearing up to Manage Risks from Climate Change and Environmental Degradation (Frankfurt: European Central Bank – Banking Supervision, November 2022), https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.thematicreviewcerreport112022~2eb322a79c.en.pdf.

[2] European Central Bank, Guide on climate-related and environmental risks: Supervisory expectations relating to risk management and disclosure (Frankfurt: European Central Bank – Banking Supervision, November 2022), https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.202011finalguideonclimate-re.

[3] The ECB's guidance on materiality assessment describes materiality as information where its omission or misstatement could change or influence economic decision-making, which is similar to U.S. concepts of items in disclosures being material if they would influence a reasonable investor. Accordingly, the ECB's guidance (consistent with EBA expectations) expects firms to have policies for assessing the appropriateness of their disclosures, including their verification and frequency, including how materiality of climate and environmental-related risks are assessed. Further, as the ECB guidance reaffirms EBA guidelines in the assessment of materiality of certain information, institutions should pay particular attention not only to their business model, long-term strategy, and the overall risk profile, but also to the influence of the economic and political environment, the assumed level of relevance of information for users, and the relationship with developments in risks and disclosure needs.

[4] European Central Bank, The EBA publishes its roadmap on sustainable finance (Frankfurt: European Central Bank – Banking Supervision, December 2022), https://www.eba.europa.eu/eba-publishes-its-roadmap-sustainable-finance.

[5] Financial Stability Oversight Council, Report on Climate-Related Financial Risk 2021 (Washington, D.C.: Financial Stability Oversight Council, 2021), https://home.treasury.gov/system/files/261/FSOC-Climate-Report.pdf.

[6] See draft principles for climate-related financial risk management from the OCC, the FDIC, and the Federal Reserve: Principles for Climate-Related Financial Risk Management for Large Banks (occ.gov), 2022-03-29-notational-fr.pdf (fdic.gov), and Federal Register : Principles for Climate-Related Financial Risk Management for Large Financial Institutions.

[7] In September 2022, the Federal Reserve Board announced that six of the nation's largest banks will participate in a pilot climate scenario analysis exercise designed to enhance the ability of supervisors and firms to measure and manage climate-related financial risks. The OCC's survey of banks for climate-related financial risk extended in January 2022, Federal Register : Agency Information Collection Requirements; Information Collection Renewal; Comment Request; Climate Risk Range of Practice Questionnaire, has not led to a public release of results.

[8] Adam Levy, Creating climate risk programs for today—and tomorrow (Chicago: KPMG LLP, 2022), https://advisory.kpmg.us/blog/2022/creating-climate-risk-programs.html.

[9] To understand the KPMG insights in these areas, see for example: (1) https://advisory.kpmg.us/blog/2022/start-transition-risk-evaluation-journey.html; (2) https://advisory.kpmg.us/blog/2022/considerations-for-climate-stranded-assets.html.

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