# Climate-Related and Environmental Risks in EU Banking Supervision[1]

Legal adviser **Lucía Piazza DOBARGANES**[2]

***Abstract***

*Climate-related and environmental pose a threat to financial stability and at credit institutions' level. This paper delves into the on-going European Union initiatives for a sustainable banking sector, elaborates on how addressing this newly-identified source of financial risk fits within the mandate of prudential supervisors and provides an insight on their treatment under the current prudential framework for European credit institutions.*

***Keywords:*** *banking law, climate change, environmental risks, European credit institutions.*

***JEL Classification:*** K22, K32

## 1. Introductory considerations

Climate change and environmental degradation has become a major concern for policy makers, market participants and society in general. The increasing awareness on the urgency of a global response led to the adoption by many governments of the UN 2030 Agenda for sustainable development[3] and the Paris agreement on climate change[4] in 2015.

To tackle global warming, the Paris agreement set the clear objective of holding the increase in the global average temperature to well below 2°C above pre-industrial levels and pursuing efforts to limit it further to 1.5°C (article 2(1)(a) of the Paris Agreement).

Achieving this goal will require a drastic reduction of greenhouse gas emissions and thus a structural transition to a low-carbon economy. Consequently, the parties also aim to align "*finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development"* (article 2(1)(c) of the Paris Agreement).

The Paris agreement devised an international cooperation framework where the parties send their pledges – the so-called nationally determined contributions (NDC)- setting their own "ambitious efforts" to mitigate climate change (article 3 of the Paris Agreement). While scholars have discussed the binding nature of all[5] or part[6] of the Paris

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[1] This article is the sole exclusive responsibility of the author and does not necessarily reflect the opinion of the Banco de España or the Eurosystem.

[2] Lucía Piazza Dobarganes - Head of the SSM Affairs Unit at the Legal Department of *Banco de España*, Spain, lucia.piazza@bde.es.

[3] Resolution 70/01 adopted by the United Nations General Assembly on 25 September 2015.

[4] The Paris agreement was adopted within 21st Conference of the Parties (COP-21) to the United Nations Framework Convention on Climate Change (UNFCCC) on 12 December 2015 and entered into force on 4 November 2016.

[5] Anne-Marie Slaughter, *The Paris approach to global governance*, Project-Syndicate, 28 December 2015.

[6] Lavanya Rajamani, *The 2015 Paris Agreement: Interplay Between Hard, Soft and Non-Obligations*, „Journal of Environmental Law", volume 28, issue 2, July 2016, pp. 337–358.

agreement, some noted that it shifted direction from other international regulatory initiatives –such as the Kyoto Protocol[7]- by departing from binding targets and following a more realistic bottom-up approach based on accountability[8] and peer pressure[9].

The European Union (EU) and all its Member States are among the more than 190 parties to the agreement[10] and have jointly committed themselves to a reduction of at least 55% in their greenhouse gas emissions by 2030 compared to 1990[11]. This target is a key milestone towards the final goal of an EU economy with net-zero greenhouse gas emissions and thus climate-neutral by 2050[12].

## 2. The European authorities' initiatives for a sustainable banking sector

In 2016, the European Commission established the EU High-Level Group (HLG) on sustainable finance to provide advice on the reforms needed at pan-European scale to facilitate (i) financial flows towards sustainable investments and (ii) explore the steps that financial institutions and supervisors should take to protect the stability of the financial system from environmental risks (including, where relevant, social and governance risks)[13].

Building on their recommendations for the EU financial sector[14], the Commission issued an action plan on financing sustainable growth[15]. Sustainable finance is therein defined as "*the process of taking due account of environmental and social considerations in investment decision-making, leading to increased investments in longer-term and sustainable activities"*, for which the governance arrangements of the relevant public and private institutions play a key role. As opposed to narrower approaches that limit the definition to strict environmental concerns and natural disasters, the Commission took a wider focus that takes into account the environmental, social and governance (ESG) dimensions of sustainability.

To this end, along with the objectives of reorienting capital flows towards sustainable investments and managing environmental and social risks, the Commission action plan also aims to foster transparency and long-termism in financial and economic activity. Fulfilling this three-fold objective will entail a thorough review of the EU financial policy framework, including legislative and regulatory action on targeted areas[16].

In connection with the banking sector, point 8 of the Commission action plan envisioned to reflect on including ESG factors in "*risk management policies and the*

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[7] The Kyoto Protocol to the UNFCC was adopted on 11 December 1997 and entered into force on 16 February 2005.

[8] Falkner, R., *The Paris Agreement and the New Logic of International Climate Politics*, „International Affairs", volume 92, issue 5, September 2016, pp. 1107-1125.

[9] ECB report on institutions' climate-related and environmental risk disclosures, ECB, November 2020, p.6.

[10] Status at 28 February 2021 as per the UN Depositary of Treaties.

[11] Update of the NDC of the European and its Member States, 18 December 2020, interim UN NCD Registry.

[12] Communication COM/2020/562 Stepping up Europe's 2030 climate ambition Investing in a climate-neutral future for the benefit of our people, 17 September 2020.

[13] Commission decision of 28.10.2016 on the creation of a High-Level Expert Group on Sustainable Finance in the context of the Capital Markets Union.

[14] Report of the European Commission's High-Level Expert Group on Sustainable Finance, January 2018

[15] Communication COM/2018/097 Action Plan: Financing Sustainable Growth, 8 March 2018.

[16] See annex III of the Commission action plan.

*potential calibration of capital requirements of banks as part of the Capital Requirements Regulation and Directive (...) where this is justified from a risk perspective, to safeguard the coherence and effectiveness of the prudential framework and financial stability*." Under point 9, the Commission highlighted the importance of strengthening sustainability in corporate disclosures and reporting rules in order to enable investors and stakeholders to assess the long-term value and sustainability of institutions and their risk exposures.

Accordingly, under the EU banking package reform of 2019, the European Banking Authority (EBA) was mandated[17] to assess and elaborate on how ESG factors could be integrated into the three pillars of prudential supervision[18] (see articles 98(8) of the CRD5[19] and articles 434a and 501 of the CRR2[20]). Currently, the EBA is working on (a) the integration of ESG factors in strategy and risk management (b) the development of qualitative and quantitate key-metrics and associated disclosures, (c) the design of dedicated methodologies for stress testing and scenario-analysis, and on (d) the merits of a dedicated prudential treatment linked to ESG objectives (namely, the introduction of a "*green-supporting factor*" or a "*brown-penalising factor*" for capital requirements[21]).

In parallel with this process, the European Central Bank (ECB), the European Supervisory Authorities[22] and Member States central banks and prudential supervisors are participants or have contributed to other international initiatives in the field of sustainable finance. For its relevance, reference should be made to the Network of Central Banks and Supervisors for Greening the Financial System (NGFS)[23] and the Task Force on Climate related Financial Disclosure (TCFD) stablished by the Financial Stability Board (FSB).

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[17] See EBA action plan of sustainable finance, December 2019, for a detailed explanation of the EBA's specific mandates under EU law, as well as the planned timelines and expected deliveries for the fulfillment of such mandates.

[18] Namely, minimum capital requirements (Pillar 1), supervisory review (Pillar 2) and market discipline (Pillar 3).

[19] Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures, OJ L 150, 7.6.2019, p. 253–295.

[20] Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements, and Regulation (EU) No 648/2012, OJ C 50, 9.2.2018, p. 3-62.

[21] See, for instance, Delgado, M., *Energy transition and financial stability. Implications for the Spanish deposit-taking institutions*, „Financial Stability Review", n. 37, Banco de España, 2019, pp. 33-43 and Dankert, J., van Doorn, L., Reinders, H., and Sleijpen, O., *A Green Supporting Factor — The Right Policy?*, SUERF policy note no. 43, October, 2018.

[22]The European supervisory authorities (ESAs) are the EBA, the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA).

[23] The NGFS was established at the Paris "One Planet Summit" in December 2017. As of 15 February, it gathers 87 central banks and supervisors, and 13 observers that share best practices and contribute to the management of ESG risks in the financial sector and to the transition to a sustainable economy.

### 3. The role of the EU prudential supervisors in light of their mandates

The primary responsibility for tackling climate change, environmental degradation and natural disasters rests with elected governments and legislatures, which should also steer the smooth transition to a low-carbon economy. At EU level, article 192 of Treaty on the Functioning of the European Union (TFEU)[24] confers on the European Parliament and the Council (namely, the Union's legislators) the responsibility for pursuing the objective of the Union policy on the environment as provided in Article 191 TFEU.

However, the pressing urgency to tackle climate change coupled with the stark influence that financial authorities may have in investment decisions and in the allocation of funds and credit have given rise to an intensive debate on whether such authorities should play a role in addressing environmental concerns, and if so, to what extent. A significant share of the discussion revolves around the role of central banks and financial regulators, but prudential supervisors – on stand-alone role[25] or together with the aforementioned roles – are also under the spotlight.

Being prudential supervisors bound by their public mandates, a legal approach to the debate could focus on whether addressing environmental concerns and promoting a smooth transition to a low-carbon economy are deemed consistent with their mandates. Although the mandates may differ significantly across jurisdictions[26], the implication of financial authorities in achieving these goals will also depend on how such mandates are interpreted and the willingness to act[27] within their remits.

#### 3.1. The role under a narrow interpretation of the mandate

Even if one follows a narrow interpretation of the mandate of prudential supervisors, the case for incorporating climate-related and environmental considerations into the discharge of prudential supervision can be grounded on the evidence pointing on the economic risk they pose to credit institutions and financial stability[28].

Indeed, credits institutions[29] may be vulnerable to the financial risks deriving from the physical effects of climate change and other environmental factors (*"physical risks*"), which can be either acute (where they arise from extreme weather events or natural disasters -such as droughts, flood, storms, fire or heatwaves- that may damage facilities and disrupt value chair) or chronic (where they arise from long-term changes in weather and environmental conditions, such as temperature changes, sea-level rise,

[24] Article 194 of the Consolidated version of the Treaty on the Functioning of the European Union, OJ C 326, 26.10.2012, p. 47–390.

[25] See, for example, Schoenmaker, D. and van Tilburg, R., *What role for Financial supervisors in addressing environmental risks?*, „Comparative Economic Studies", 58, January 2016, pp. 317-334.

[26] Dikau. S. and Volz U., *Central banking, climate change and green,* ADBI Working Paper Series no. 867, September 2018.

[27] Campiglio, E., Y. Dafermos, P. Monnin, J. Ryan-Collins, G. Schotten, and M. Tanaka, *Climate change challenges for central banks and financial regulators*, Nature Climate Change, 8, 2018, pp. 462-468.

[28] In this vein, NGFS, *A call for action*, cited, p. 2.

[29] ESG factors at institutional level although they also pose a risk to financial stability. In any case, the ensuing distinction between physical, transition and legal risks is applicable to both levels.

water stress, biodiversity loss, land-use changes or soil productivity)[30]. Besides, institutions may be exposed to the risks resulting from the process of adjustment to a carbon-neutral economy ("*transition risks*"), which may arise from policy, technological and behavioural changes[31]. Both physical and transition risks are interdependent and may encompass losses and costs related to litigation and other liabilities arising from environmental, social and governance factors ("*legal risks*")[32].

These ESG factors are deemed "*not just future risks*" but risks that are already impacting the balance sheet of financial institutions[33]. Consequently, they can be seen as drivers of conventional types of prudential risks (such as credit risk, operational risk, market risk, or liquidity risk)[34], whose magnitude and distribution will depend on whether they are addressed promptly and in orderly fashion[35], and thus fall within the remit of prudential supervisors (see, for instance, article 4(1) of the SSM Regulation[36] conferring prudential supervisory tasks on the ECB).

### 3.2. The role under a wider interpretation of the mandate

On a theoretical note, prudential supervisors, as public authorities, should contribute within its powers to the fundamental principles of social and economic policy and to the fulfilment of international commitments on this area. Besides the guiding principles providing for environmental protection at EU and national level (see, for instance, article 45 of the Spanish Constitution[37]), article 3(3) of the TFEU specifically stablishes that "*The Union shall establish an internal market and (…) shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment"*.

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[30] We follow the definition under the Communication C/2019/449 from the Commission — Guidelines on non-financial reporting: Supplement on reporting climate-related information, OJ C 209, 20.6.2019. Similarly, the EBA Discussion Paper on management and supervision of ESG risks for credit institutions and investment firms (EBA/DP/2020/03), 30 October 2020 and the Guide on climate-related and environmental risks, ECB, November 2020.

[31] See paragraph 68 of the Discussion Paper EBA/DP/2020/03, cited.

[32] Depending on the classification, legal risks (also called "liability risks") may be considered as a separate category of risks or as part of either physical or transition risks. See paragraph 61-67 of EBA/DP/2020/03.

[33] Guide for Supervisors Integrating climate-related and environmental risks into prudential supervision, NGFS, May 2020, p. 10.

[34] The ECB also refers to „*other non-Pillar 1 risks such as migration risk, credit spread risk in the banking book, real estate risk and strategic risk*". See p. 11 of the cited ECB Guide.

[35] See *A call for action: Climate change as a source of financial risk*, NGFS, April 2019; Too late, too sudden: Transition to a low-carbon economy and systemic risk, ESRB 2016; *The Price of Doing Too Little Too Late The impact of the carbon bubble on the EU financial system*, Green European Foundation, Green New Deal Series volume 11, February 2014.

[36] Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, OJ L 287, 29.10.2013.

[37] Constitución Española, BOE n. 311, 29 December 1978. Article 45 can be translated as follows: "*1. Everyone has the right to enjoy an environment suitable for personal development, as well as the duty to preserve it. 2.The public authorities shall safeguard rational use of all natural resources with a view to protecting and improving the quality of life and preserving and restoring the environment, by relying on essential collective solidarity (…)*".

Consequently, one could conclude that EU prudential supervisors should contribute to the achievement of these goals without prejudice to their primary objectives. This approach is expressly followed by article 127(1) TFUE as regards the European System of Central Banks (ESCB)[38] and should also apply to EU prudential supervisors in a similar fashion. In the case of the European Central Bank (ECB), it should also be noted that the legal basis that allows the conferral of prudential supervisory tasks on the ECB lies on this same article 127 TFUE (in particular, in its paragraph 6)[39].

As a final remark, it should not be forgotten that many EU prudential supervisors combine this role with the discharge of other monetary[40], regulatory or macro-prudential duties, which may amplify their margin of action whether under a narrow or a wider interpretation of the mandates.

## 4. The state-of-the play under the EU prudential framework

### 4.1. The same, but different risks

As stated, ESG factors are drivers of typical prudential risks and thus credit institutions shall take them into account in their strategies and processes to adequately assess, manage and cover risks in line with the provisions under the CRR[41] and the national law transposing the CRD[42]. To this end, adequate governance arrangements and the involvement of directors and managers are of essence (see, for instance, articles 73 et seq. of the CRD). Also, where applicable, ESG risks shall be disclosed to the market under the Pillar 3 regime provided by Part Eight of the CRR (articles 431 et seq. of the CRR).

Notwithstanding the foregoing, ESG factors have particularities that made them distinct from other drivers of prudential risk. Firstly, the very concept of ESG factors and risks is yet to be accurately determined. Despite the growing efforts for harmonisation at international level, the complexity and multidimensional nature of climate change and environmental degradation have led to different understandings of how ESG risks should be defined. Some difficulties arise from the fact that ESG factors may either have a positive or a negative impact for the financial situation of credit institutions, that they are linked to non-financial characteristics and patterns (for instance, greenhouse gas emissions or social awareness) and that they may impact different stakeholders in the value chain of a company. Finally, the delimitation of the concept is further complicated by the underlying political, economic and scientific uncertainties around the consequences and means to tackle ESG concerns, which may

[38] Also, article 2 of the Protocol on the statute of the ESCB and of the European Central Bank.

[39] On a similar note, see the Eurosystem reply to the European Commission's public consultations on the Renewed Sustainable Finance Strategy and the revision of the Non Financial Reporting Directive.

[40] That is the case, for instance, of the European Central Bank and Banco de España, among many others.

[41] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012.

[42] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, OJ L 176, 27.6.2013.

affect to their eventual materialisation as well as on the timing and magnitude of their impact to the financial situation of credit institutions[43].

Another interesting peculiarity arises from the evidence that the effects of climate change and environmental degradation unfold over a longer timeframe than the one usually considered for other drivers of financial risk. This what the former Governor of the Bank of England Mark Carney defined as the "*tragedy of the horizon*": the effects of climate change unfold over a time horizon that "*goes beyond the business cycle; the political cycle; and the horizon of technocratic authorities, like central banks, who are bound by their mandates*"; which may have no incentive to tackle them [44].

In the same vein, credit institutions, regulators and supervisors take into account a shorter timeframe when it comes to assess and manage prudential risk. As recently explained by Andrea Enria, Chair of the Supervisory Board of the ECB: *"Banks tend to measure and manage risks within a fairly short time frame. Their internal models seldom look beyond the next 12 months or, at most, the current economic cycle. Regulatory requirements confirm and reinforce this short-sighted approach"* [45]. The EBA have also elaborated on the mismatch of the time-horizon considered by supervisors in scenario analysis or in the supervisory review when evaluating how to include ESG risks. For instance, it pointed out that the adoption of supervisory measures such as Pillar 2 capital add-ons is based on a forward-looking perspective of 12 months and consequently recommended to expand the horizons for supervisory reviews[46] and its follow-up measures.

These distinct characteristics of ESG factors as a newly-identified source of financial risk have led to the realisation that they require further elaboration from a prudential perspective. While the revision of the EU prudential framework is in progress, several EU authorities have adopted measures and guidance on how ESG factors should be managed under current regulatory framework.

Besides, as a first step for supervisors, market participants and managers to gain deeper knowledge on the current situation for financial institutions, there has already been significant developments to stablish a dedicated regulatory disclosure and reporting regime for ESG risks.

### 4.2. Supervisory expectations and stress-testing

In line with the recommendations of the NGFS[47], the European Central Bank (ECB)[48] and several Member-states supervisory authorities[49] have conveyed their

[43] The EBA has been mandated under article 98(8) CRD5 to develop "*a uniform definition of ESG risks, including physical risks and transition risks; the latter shall comprise the risks related to the depreciation of assets due to regulatory changes",* and to develop qualitative and quantitative criteria for the assessment and management of their impact on the financial stability of institutions in the short, medium and long term. For more information, see the Discussion paper EBA/DP/2020/03, cited.

[44] Carney, M., *Breaking the tragedy of the horizon - climate change and financial stability*, London, September 2015.

[45] Enria, A., ECB Banking Supervision's approach to climate risks, June 2020.

[46] See section 7 of the Discussion paper EBA/DP/2020/03, cited.

[47] NGFS Guide for Supervisors, cited, p. 38.

[48] ECB Guide on climate-related and environmental risks, cited.

[49] See, for instance, Supervisory expectations relating to the risks posed by climate change and environmental degradation, Banco de España, October 2020; *Gouvernance et gestion des risques*

expectations and views on how climate-related and environmental risks should be managed and disclosed under the current prudential framework.

In general, these are non-binding instruments (which have been issued under names such as of "guide", "guidance" or "good practices") which encourage credit institutions to assess whether, and to what extent, their current management and disclosure practices for ESG risks are sound, effective and comprehensive in light of the applicable prudential rules and the relevant interpretation provided by each supervisor.

Albeit following a different order or structure, these documents generally start by proposing a definition of ESG risks and its main characteristics as drivers of financial risks and continue by covering the supervisory expectations in the areas of governance, business model and strategy, risk management and disclosures of ESG to third parties under the current prudential framework (which certain supervisors explicitly cite and refer to[50]).

In terms of scope and subject matter, it should be noted that due to the different mandates of EU prudential supervisors, some of these documents cover other types of financial institutions (such as investment firms or insurance undertakings[51]) or fields that go beyond the prudential framework for credit institutions under the CRR/CRD package (for instance, rules on corporate reporting or on investment services[52]).

While some recognise that the relevant regulatory landscape is currently evolving and the need to take into account proportionality, they all encourage credit institutions to progressively deepen and enhance the way they address and manage ESG risks[53].

Notably, the ECB guide is applicable as of the date of its publication and follows a "*comply or explain*" approach. In particular, the ECB foresees those institutions under its direct supervision (i.e. significant institutions under the Single Supervisory Mechanism[54] of the Banking Union) will be asked, from early 2021, to explain the "*existing divergences in their practices from the supervisory expectation (…) and to inform the ECB of arrangements aimed at progressively addressing these expectations*"[55]. This is deemed a first step to take into account the outcomes of this supervisory dialogue in the future supervisory review and evaluation processes under articles 97 et. seq. of the CRD ("SREP") and to adopt follow-up measures where needed[56]. In general terms, the SREP may entail the issuance of recommendations, specific supervisory expectations as well as pillar 2 measures where applicable under article 16 of the SSM Regulation and under the national transposition of articles 104-104b of the CRD. Notwithstanding this, the specific treatment of ESG factors in the SREP is still under discussion[57].

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*climatiques par les établissements bancaires: quelques bonnes pratiques*, ACPR, May 2020; Guide for Managing Sustainability Risks, FMA, July 2020; Good Practice document, DNB, 2020, and Guidance Notice on Dealing with Sustainability Risks, BaFin, 2019.

[50] Of particular interest may be section 2.4 of the ECB guide which describes the general prudential framework.

[51] See the BaFin Guidance, cited, or the FMA Guide, cited.

[52] See the FMA Guide, cited.

[53] See the ECB Guide, cited, p. 7; and section 2 of the Banco de España's expectations, cited, pp. 6-76.

[54] According to article 6 of the SSM Regulation.

[55] See section 2.2 of the ECB guide, cited, p. 7.

[56] See ECB Press release of 27 November of 2020.

[57] EBA/DP/2020/03 Discussion paper, cited.

Meanwhile, central banks and supervisors as well as other EU authorities are also delving into gaining deeper knowledge on how ESG risks may affect the economy and the financial sector, and to this end are performing system-wide scenario analysis or stress-tests at institution level[58]. Accordingly, the EBA Regulation[59] now expressly refers to its tasks and powers as regards ESG risks assessment and monitoring (see articles 8 and 29), which are to be incorporated in the performance of its EU-wide assessments of the resilience of financial institutions (article 23 and 32).

In the area of banking supervision, the ECB has announced that its next supervisory stress test under article 100 of the CRD (which will be performed in 2022) will focus on climate-related risks[60].

### 4.3. Disclosure and reporting of ESG risks

The non-financial reporting directive (NFRD[61]) requires large public-interest companies (i.e. listed companies, banks and insurance companies with more than 500 employees) to disclose information on the way they operate and manage certain ESG risks. In particular, credit institution under the scope of the NFRD have to publish a report on their business model, policies and related due diligence processes and outcomes; principal risks and risk management, as well as key-performance business indicators in connection with, as a minimum, the following matters: (a) environmental protection, (b) social responsibility and treatment of employees, (c) respect for human rights, (d) anti-corruption and bribery, and (e) diversity - directors (in terms of age, gender, educational and professional background- in their board of directors (article 19a of the NFRD).

This information should be disclosed to the extent necessary for an understanding of the development, performance, position and impact of the activities of the concerned institution (that is, to the extent they are material). According to the what the Commission, this entails that they *"should disclose not only how sustainability issues may affect the company, but also how the company affects society and the environment. This is the so-called double materiality perspective*.[62]"

The NFRD was supplemented with two non-binding guidelines[63] issued by the Commission with a view to facilitating more consistent and comparable disclosures of ESG information[64]. In particular, the latter of those guidelines - Communication C/2019/4490 - focus solely on the reporting of climate-related information and integrates

[58] See examples provided in the Annex to the Guide to climate scenario analysis for central banks and supervisors, NGFS, June 2020.

[59] Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC.

[60] See ECB Press release of 27 November of 2020.

[61] Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups, OJ L 330, 15.11.2014.

[62] Consultation document on the review of non-financial reporting directive, 20 February 2020.

[63] Communication C/2019/4490 from the Commission — Guidelines on non-financial reporting: Supplement on reporting climate-related information, OJ C 209, 20.6.2019*;* and the already cited Communication C/2019/4490.

[64] Article 2 of the NFRD.

the recommendations of the TCFD[65].

Building on the aforementioned double-materiality perspective, the Communication C/2019/4490 proposes a limited number of recommended climate-related disclosures in connection with the reporting areas listed in the NFRD, which companies may consider taking into account their materiality. Considering that credit institutions and insurance companies are "*both providers and users of climate-related information*" and thus they can exacerbate o help mitigate ESG risks, Annex I provides further guidance for these companies and for some of their activities (such as lending, investing, insurance underwriting or asset management).

The NFRD is currently under review[66] and has been recently complemented with a regulation which establishes an EU-wide classification system to determine whether an economic activity is environmentally sustainable (the "Taxonomy Regulation")[67]. In particular, an economic activity shall qualify as environmentally sustainable where it contributes substantially to one or more environmental objectives[68], does not significantly harm other environmental objective[69], is carried out in compliance with certain minimum social and governance safeguards[70], and complies with technical screening criteria set by delegated acts of the European Commission (article 3 of the Taxonomy Regulation).

Credit institutions under the scope of the NRFD will be required to include in their non-financial statement's information on how and to what extent their activities are considered as environmentally sustainable under the Taxonomy Regulation. In particular, as of 1 January 2022 or 1 January 2023 (depending on the environmental objective), they shall disclose: (a) the proportion of their turnover derived from products or services associated with economic activities that qualify as environmentally sustainable; and (b) the proportion of their capital expenditure and of their operating expenditure related to assets or processes associated with economic activities that qualify as environmentally sustainable (articles 8 and 27(2) of the Taxonomy Regulation).

From a prudential perspective, Part Eight of the CRR (articles 431 et seq. of the CRR) requires credit institutions to disclose comprehensive information on their risk profile as part of the Pillar 3 disclosures. In this vein, they should include relevant information and key metrics regarding ESG risks that where this information is deemed material (but is not proprietary nor confidential). As with any other type or risk, materiality of the information will depend on whether its omission or misstatement could change or influence the assessment for the purpose of economic decision-making (art. 432 of the CRR). To this end, consideration should be given to the EBA Guidelines on

[65] Recommendations of the Task Force on Climate-related Financial Disclosures – Final Report, June 2017.
[66] See consultation document of the NFRD, cited.
[67] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088, OJ L 198, 22.6.2020.
[68] The objectives are set out in article 9 of the Taxonomy Regulation and further specified in articles 10 to 16: (a) climate change mitigation, (b) climate change adaptation, (c) sustainable use and protection of water and marine resources, (d) transition to a circular economy, (e) pollution prevention and control, and (f) protection and restoration of biodiversity and ecosystems.
[69] As specified in article 17 of the Taxonomy Regulation.
[70] As specified in article 18 of the Taxonomy Regulation.

materiality, proprietary and confidentiality and on disclosure frequency[71].

Also, the new article 449a of the CRR (which was introduced by the CRR2) requires large institutions[72] with EU traded securities to disclose information on ESG risks, including physical and transitional risks, from 28 June 2022, on an annual-basis for the first year and biannually thereafter.

Finally, it should be noted that credit institutions may be subject to additional ESG disclosures from a conduct and transparency perspective if they provide portfolio management services (see article 2(1)(j) of the Regulation on sustainability-related disclosures in the financial services sector[73]) or where they fall under the remits of the Climate Benchmarks Regulation[74].

## 5. Conclusion

Climate change and environmental degradation, as well as their social and governance implications, are major drivers of financial risk that can impact the balance sheet of credit institutions through physical and transitional channels. Although these risks can be categorised into one or several types of conventional prudential risks, they also have specific features that requires further elaboration from a prudential perspective.

This understanding coupled with the urgency to address the threat posed has led to significant regulatory developments for a sustainable EU banking sector that will continue over the coming months and years. Within their mandates, prudential supervisors will also play a substantial role in how credit institutions address and manage these risks under the current and upcoming EU banking framework.

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[72] According to article 4(1)(146) CRR, "large institution" means an institution that meets any of the following conditions: (a) it is a global systemically important institution (G-SII), (b) other systemically important institution (O-SII) under article 131 of the CRD, (d) it is, in the Member State in which it is established, one of the three largest institutions in terms of total value of assets, and (e) the total value of its assets on an individual or consolidated basis is equal to or greater than EUR 30 billion.

[73] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector, OJ L 317, 9.12.2019.

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