

20 December 2022

Thematic Review on Climate-Related and Environmental Risks – Less Significant Institutions

Executive Summary

The ECB and MFSA have reviewed the preparations banks are making to assess and mitigate the risks posed by climate change to their business models. The authority has concluded that all banks in Malta need to strengthen their governance arrangements by improving their understanding of climate related and environmental risks (C&E risks), put in place clearer plans to assess climate related risks and integrate them into their risk management frameworks, and engage with their customers to collect data so they can meet their disclosure obligations.

Both physical and transition risks will impact the performance of their borrowers and access to capital and debt markets will be influenced by the quality of climate related disclosures. It is therefore important that all banks engage with their customers early to develop appropriate plans to mitigate risks and prepare for new regulatory requirements in the coming years.

The ECB has published the results of the SSM wide thematic review as well as a good practice guide. Banks are encouraged to use this information to support them during their in house work.

Thematic Review on Climate-Related and Environmental Risks

In November 2020, the ECB published its Guide on climate-related and environmental risks (referred to as “The Guide”) which set out 13 supervisory expectations for banks to align with. The guide describes how banks are expected to consider climate-related and environmental risks as drivers of existing risk categories. It aims to enhance the industry’s awareness and preparedness for managing climate-related and environmental risks.

This Thematic Review on Climate-related and Environmental risks, carried out jointly by the ECB and National Competent Authorities including the MFSA, is one of the initiatives by regulators to focus on how climate related and environmental risks will impact business strategies, governance, and risk management frameworks. It covered large and medium sized banks across the SSM.

In Malta, we assessed banks against the core modules. The MFSA was seeking to review evidence that banks were starting their preparations covering the points below.

- The extent to which banks have started to assess the materiality of risks posed to them and mapped the climate and environmental risk drivers (transmission and physical) to their overall risk profile and existing prudential risk set which includes, capital and credit risk, liquidity risk, market risks, legal and reputational risk;
- Whether the board evidences appropriate knowledge and understanding of climate and environmental risk so that it can exercise appropriate control over business planning;
- How risk management frameworks have started to adapt by integrating KPIs into their Risk Appetite Statements, or whether all parts of the three lines of defence have suitable arrangements in place, potentially encapsulated in an ESG policy framework;
- If the banks have started to assess the operational risk posed by potential physical risks;
- The extent to which client handling strategies have resulted in dialogue, policy action, or are identifying data gathering challenges and those data issues have been integrated into the data governance strategy of the bank. Clients will also need support strategies;
- And, whether the board, management and others are supported through appropriate training, People and Culture KPIs are integrated into the assessment and remuneration framework.

The objective of this review was to assess the soundness, effectiveness, and comprehensiveness of banks' climate-related and environmental risk management practices and align with the expectations as published by the ECB in its guide on climate-related and environmental risks.

Outcomes

- The review demonstrated that banks in Malta are in the very early stages of taking steps to integrate C&E risk into their risk management frameworks. Increased momentum will be needed so that banks hit the expected legislative deadlines.
- When evaluating the existence and quality of banks practices for C&E risks, some banks have initiated a few basic practices on C&E risks but there is a lot of work to do to move beyond the first phase of preparation.
- Banks C&E risk practices do not yet comprehensively consider their main portfolios and business lines, the sectors, and geographies in which they are active.
- Banks do not have systems to evaluate relevant risk drivers such as the impacts of market forces including technology on transition risks. Similarly, banks do not yet map the physical risk impacts to financial risks.
- Banks need to develop mechanisms to consider the various time horizons over which risks can materialise.
- Some banks informed the Authority about plans to align themselves with the ECB guide, these plans have not yet been actioned.
- The MFSA is asking banks to quicken their preparations and present progress to the MFSA.