ORGANIZING SUSTAINABILITY AT BANK LEVEL: RELEVANCE FOR BULGARIA AND GREECE

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Abstract: *Today, there is no dispute anymore that success for a business comes through the application of the principles of sustainability in all its aspects. The understanding of sustainability translates into the implementation of a holistic approach to the financial and overall management of a company. Banks are major players in the economy, and they are compelled to follow this approach. How is it to be applied in practice, however? The current paper aims at providing a high-level answer to this question by providing information and shedding light on the emerging ECB and international organizations standards and requirements and outlines their relevance for the banks in Bulgaria and in Greece.*

Key words: *Sustainability, Banks, ECB*

Introduction

In 2020 the European Union (EU) officially sealed its decisiveness to move collectively towards a zero-emissions economy by 2050 by agreeing on the Green Deal. This was the apex of years of efforts at country level undertaken by several EU member states to counteract the phenomena that have been becoming increasingly evident - climate change and pollution along with the deepening need for imports of key raw materials.

The Deal envisages the most sizable transformation ever in history to take place in Europe's economy so that the most immediate challenges ahead of societies today - pollution and resource scarcity - be met. For that to take place, a change of the underlying economic model is required - from linear based on the „take-make-dispose" principle to a circular – „take-make-recycle-reuse" economic model. The circular model is expected to solve both challenges thus boosting economic efficiency and curbing pollution, and therefore - climate change.

Such changes require massive financial means to take place. Since banks are at the heart of the EU's lending their role in this large-scale transition is of key importance. They will have to be in a position to properly meet the needs of businesses and households in the coming years so that the targets set out in the Green Deal to be accomplished at the EU level. This will inevitably impact their product portfolio and risk management. Here comes the key question: how to organize management of the multifaceted sustainability issues within banks? The answer requires understanding the role and the policy of the ECB in that direction, and then looking into the particular requirements it has for banks. In addition, international organizations, in the first place the United Nations Environmental Program Finance Initiative (UNEP FI), are offering their approach to sustainability management at banks though the Principles of Responsible Banking. And while the ECB requirements and recommendations are applicable to all banks in Greece and to only the systemic one's in Bulgaria, the PRB are open to all banks, independent of their country of operation and size.

ECB's Stance on Sustainability with Respect to Its Own Operations.

By adopting an ambitious plan to incorporate climate change considerations into its policy framework, the European Central Bank (ECB) has taken the first step towards making its policies more environmentally friendly. In making this decision, the Governing Council demonstrates its dedication to incorporating environmental sustainability into its monetary policy in a more systematic manner. Climate change and environmental sustainability were a major focus of the 2020-21 strategy review.

The ECB recognizes the importance of incorporating climate change issues into its policy framework, even if governments and parliaments have the main responsibility for addressing the issue. Changes in macroeconomic variables such as inflation, production, employment, interest rates, investment, and productivity; financial stability; and the transmission of monetary policy are all affected by climate change and the shift to a more sustainable economy. It's also worth noting that climate change and the transition to a low-carbon economy have a direct impact on the value and risk profile of the assets held on the Eurosystem's balance sheet.[1]

The ECB is placing focus on a number of particular areas:

- Macroeconomic modeling and evaluation of the consequences for the transmission of monetary policy. For the ECB, the implications of climate change and related policies on the economy, the financial system, and the transmission of monetary policy through financial markets and banks to households and businesses will be closely monitored through the use of new models and analytical methods, both theoretical and empirical.
- Analytical statistics for the assessment of the dangers of global warming. Green financial instruments and the carbon footprint of financial institutions, as well as their exposures to climate-related physical risks, will be covered by new experimental indicators developed by the European Central Bank. Starting in 2022, there will be a step-by-step improvement of these indicators in accordance with EU rules and activities in the area of environmental sustainability disclosure and reporting.
- Disclosures as a condition of collateral and asset purchasing eligibility. For collateral and asset purchases, the ECB plans to impose new disclosure requirements on private sector assets as a new eligibility criterion. As a result of these regulations, the environmental sustainability disclosure and reporting practices in the market will become more standardized, while the proportionality of the requirements for small and medium-sized businesses is maintained. In 2022, the European Central Bank will unveil a complete plan.
- Improved ability to conduct risk assessments. A climate stress test of the Eurosystem balance sheet will begin in 2022 to examine the Eurosystem's risk exposure to climate change, using the ECB's economy-wide climate stress test methodology. To that end, the ECB will check to see if the credit rating agencies recognized by the Eurosystem Credit Assessment Framework have provided all of the information necessary to understand how climate change risks are factored into their assessments. In addition, the European Central Bank is considering adopting

[1] ECB presents action plan to include climate change considerations in its monetary policy strategy, https://www.ecb.europa.eu/press/pr/date/2021/html/ecb.pr210708_1~f104919225.en.html, 8 July 2021.

minimum guidelines for the integration of climate change risks into its internal ratings.

- Collateral framework. For collateral mobilized by counterparties for Eurosystem credit operations, the ECB will take into account relevant climate change risks when examining valuation and risk control regimes. As a result, all relevant hazards, including those associated with climate change, will be taken into account. It is also important to note that the ECB will continue to keep an eye on structural market developments in sustainability products and will be ready to promote innovation in this sector as demonstrated by its decision to accept sustainability-linked bonds as collateral.
- Asset acquisitions by corporations. According to the ECB's due diligence procedures for its purchases of corporate sector assets in its monetary policy portfolios, climate change concerns are already being considered. The ECB intends to alter the allocation structure for corporate bond purchases to integrate climate change considerations in the future. Climate change measurements or commitments by issues to such targets will be part of these efforts, as would issuer alignment with EU legislation implementing the Paris agreement. Aside from that, the ECB plans to begin providing CSPP climate-related data in the first quarter of 2023.

1. The Sustainability Policy ECB Has towards Banks under Its Supervision: Relevance for Greece and Bulgaria

ECB's policy towards banks in the area of sustainability translates into a number of supervisory expectations. They are outlined in one major document - the Guide on Climate-Related and Environmental Risks for Banks, issued in November 2020,[2] and materialize in detail in other activity-specific documents, such as the European Banking Authority's Guidelines on Loan Origination and Monitoring.[3] These documents are relevant to all banks in Greece since the country is a Eurozone member state, while for Bulgaria they apply only to the banks in the so-called Group I of BNB, or the largest, systemic banks.

The Guide is a comprehensive document, it covers practically all areas of operation of banks, as well as HR, IT, audit, compliance, business continuity planning, and disclosures. In it, the ECB highlights the importance for banks to incorporate climate-related and environmental considerations across both their strategies and into their day-to-day modus operandi. These are presented in a schematized view on Fig. 1 below.

[2] More details here: https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr201127~5642b6e68d.en.html

[3] For further reference, see: Guidelines on loan origination and monitoring, https://www.eba.europa.eu/regulation-and-policy/credit-risk/guidelines-on-loan-origination-and-monitoring

Fig. 1. Allocation of climate-related and environmental considerations in a bank's operations

In particular, the Guide sets out 13 concrete expectations that the ECB has from banks. They cover different areas of banking activity, however, are intertwined and interdependent. We have analyzed them and grouped them into 6 broader categories.

The first such category is related to strategy and business development. In this area, banks are expected that:

1. They are aware of the short, medium, and long-term impacts of climate-related and environmental risks on the business environment in which they operate;
2. They incorporate climate-related and environmental risks into the formulation and implementation of their business strategy;
3. The management body considers climate-related and environmental risks when developing the overall:

- business strategy;
- objectives;
- risk management framework and
- demonstrates good oversight of climate- and environmental-related risks.

The second area of importance that the ECB outlines, is risk management, and banks are expected to do the following:

- The risk appetite framework (RAF) should explicitly integrate climate-related and environmental risks;
- Climate-related and environmental risk exposures should be reported in an aggregated form so that management and relevant subcommittees can make informed choices;
- Risk management frameworks need to incorporate climate-related and environmental concerns as drivers of existing risk categories;

- At each level of the credit-granting process, keep an eye on the risk in all portfolios and take climate-related and environmental concerns into account.

The third area of interest is capital markets, and the particular expectations from ECB to banks are the following:

- Continually monitor the impact of climate-related and environmental concerns, and build stress tests that incorporate these risks, into the Bank's present market risk positions and prospective investments.
- Determine whether or if significant environmental and climate-related risks could result in net cash outflows or a reduction in liquidity buffers, and if so, include these risks in the management of liquidity risk and the calibration of liquidity buffers.
- As part of the broader process of ensuring capital adequacy, identify and assess climate-related and environmental risks
- It is necessary for the Bank to review the suitability of its stress testing in order to incorporate climatic and environmental risks into its baseline and adverse scenarios if they exist.

The fourth sphere that banks are called to incorporate climate-related and environmental risks, is human resource management. And here they are expected to assign responsibilities within the organization for the management of climate and environmental hazards.

The next, fifth area of concern is legal issues management and business continuity management. In this specific area, banks need to consider the potential impact on business continuity and the increased reputational and liability risks that may result from environmental and climate-related disasters.

The last, sixth, area that we have grouped ECB expectations into, is related to disclosures. Climate and environmental hazards that banks consider to be significant should be made public. In this respect, banks need to pay particular attention to the European Commission's Guidelines on non-financial reporting: Supplement on reporting climate-related information, the Sustainability Finance Disclosure Regulation (SFDR), and the EU Taxonomy for sustainable activities.

2. Setting Up Sustainability Management at Bank-Level Based on International Agreements: Relevance for Greece and Bulgaria

At international governmental level, the most important agreements that define certain frameworks for sustainability management are the UN Sustainable Development Goals (SDG), the Paris Agreement, and the EU Green Deal (relevant for the EU, however impacting the rest of the world). These agreements prescribe the high-level framework for actions in all spheres of economic activities of the signatories. How are banks impacted and what are the practical implications for them stemming from these agreements? When thinking about the applicability of international agreements on banks, all banks both in Greece and in Bulgaria are affected.

In order to organize meeting the various goals and targets in the agreements, governments need to involve commercial, as well as investment banks in the process. At global level, the United Nations (UN) acts as the focal point for setting standards for the industry. For the purpose of meeting the SDG, as well as the targets set out in the Paris Agreement, in 2019 the UN together with 132 banks from 49 countries initiated the Principles for Responsible Banking (PRB). This is a voluntary initiative whose aim is to set standards for banks worldwide with regards to, generally, how they are going to contribute in the process.

More specifically, the PRB comprises six principles targeting particular areas of banking activities, and signatory banks have committed themselves to reflecting these principles in all strategic, portfolio and transaction levels of their activities:[4]

1. Alignment: requiring banks to align their business strategy with the SDGs and the Paris Climate Agreement;
2. Impact and target setting: implying that banks shall continuously increase their positive impacts and at the same time decrease their negative impacts on, and manage the risks to, people and the environment resulting from their activities, products, and services. They will set and publish targets for the areas in which they can have the most significant impacts;
3. Clients and customers: banks are to ensure that their clients and customers have a positive impact on the environment by acting in a responsible manner;
4. Stakeholders: banks will consult, engage, and collaborate with key stakeholders in a proactive and responsible manner to advance society's goals;
5. Governance and culture: banks will demonstrate their commitment to the PRB through effective governance and a culture of responsible banking;
6. Accountability and transparency: banks commit to conduct periodic reviews of their individual and collective execution of the PRB and be upfront about their good and negative affects on, and contributions to, society's goals.

To put the PRB into action, signatories must follow three procedures. They are outlined in a separateUNEP FI document, Key Steps to be Implemented by Signatories, and they include certain theoretical considerations. In order to determine the most significant potential good and negative implications that their operations may have on the societies, economies, and environments in which they operate, banks must evaluate their actions. More specifically, they have to:

1. Consider the bank's scale in specific geographic areas, industries and technologies;
2. Take into account the importance of certain challenges and priorities in nations where the bank works and
3. How large the economic, social and environmental impacts identified are[5]

Each signatory bank must submit a progress report 18 months after its joining the PRB. Each bank’s progress and then the collective progress of all signatories takes place in three steps

- Whether and how the banks have examined their present impact on people and the environment.
- How and have they done prioritization and setting of targets in areas with the greatest impact.
- And finally, what steps they have taken towards the implementation of steps to achieve the objectives.

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[4] UNEP FI. About the Principles. https://www.unepfi.org/banking/bankingprinciples/more-about-the-principles/)

[5] Paul A. Davies and Michael D. Green. 130 Banks Commit to UN Principles for Responsible Banking. The Banking Law Journal. Feb 2020, pp. 83-84, https://m.lw.com/thoughtLeadership/banks-commit-UN-principles-banking-law-journal)

Reporting progress publicly and having this reporting validated by a third-party by year four.

In October 2021 UNEP FI published the first collective progress report on the implementation of the PRB.

The report's key findings show early signs of progress. As an example:

- Sustainability has been identified as a strategic priority by 94 % of signatory banks.
- 93 % of signatory banks are investigating the environmental and social consequences of their operations.
- Targets are being set by 30% of signatory banks, with a strong collective focus on climate and financial inclusion. Within this group, 17% have set at least one aggressive target in a high-impact area (this is mainly climate mitigation and financial inclusion).[6] However, the report also identifies areas in which signatory banks can improve. For instance:

1. Data availability and quality. The analysis demonstrates that many banks are having difficulty tracking and measuring success due to the scarcity and poor quality of data, both within the banks' internal IT systems and from external data sources. As banks get a greater grasp of how to assess the influence of their goods, portfolios, and services on society and the world, they will strengthen their impact analysis.
2. Increasing action on more crucial challenges of sustainability. Certain sustainability issues appear to be underrepresented, despite the fact that science and the world community have classified them as vital. For example, only 15% of banks listed biodiversity as a critical impact area, while 23% identified human rights, despite studies and stakeholders indicating that both are significant risks and impacts that the industry must address.
3. Ascertaining that all targets are sufficiently connected to the impact analysis's findings. The targets should be consistent with the PRB's guidelines and should include all bank-financed activities. Too many banks have targets for internal operations, such as head office electricity consumption.[7]

Conclusion

Organizing sustainability management at bank level is a must for all banks in Greece since the country is a member of the Eurozone and all rules of the ECB are applicable to its banks, as well as for all systemic banks in Bulgaria due to its desire to join the Eurozone. This means they need to embrace sustainability as a core consideration in their business undertakings. In order to assist banks, navigate in the vast and complex sustainability universe the ECB has produced a specific guide in which the main steps to be taken are outlined.

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[6] See: Lovegrove, S. UNEP FI first collective progress report on the UN Principles for Responsible Banking, (UK), https://www.regulationtomorrow.com/eu/esg-uk/unep-fi-first-collective-progress-report-on-the-un-principles-for-responsible-banking/, 2021

[7] Simon Lovegrove, S. UNEP FI first collective progress report on the UN Principles for Responsible Banking, (UK), https://www.regulationtomorrow.com/eu/esg-uk/unep-fi-first-collective-progress-report-on-the-un-principles-for-responsible-banking/, 2021

Apart from that, international organizations such as the UNEP FI and their PRB, are assisting in this complicated process. And while ECB requirements are applicable to all banks in Greece but only to the systemic ones in Bulgaria, the recommendations of the PRB are open and potentially applicable to all banks who wish to abide by them. Thus banks are collecting knowledge and expertise to be in a position to meet the shifting demands of the market.

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