

# UNDERSTANDING ESG AND ITS RISK IMPLICATIONS FOR BANKS

**María J Nieto**

Banco de España

JOINT RESEARCH CENTER (JRC)

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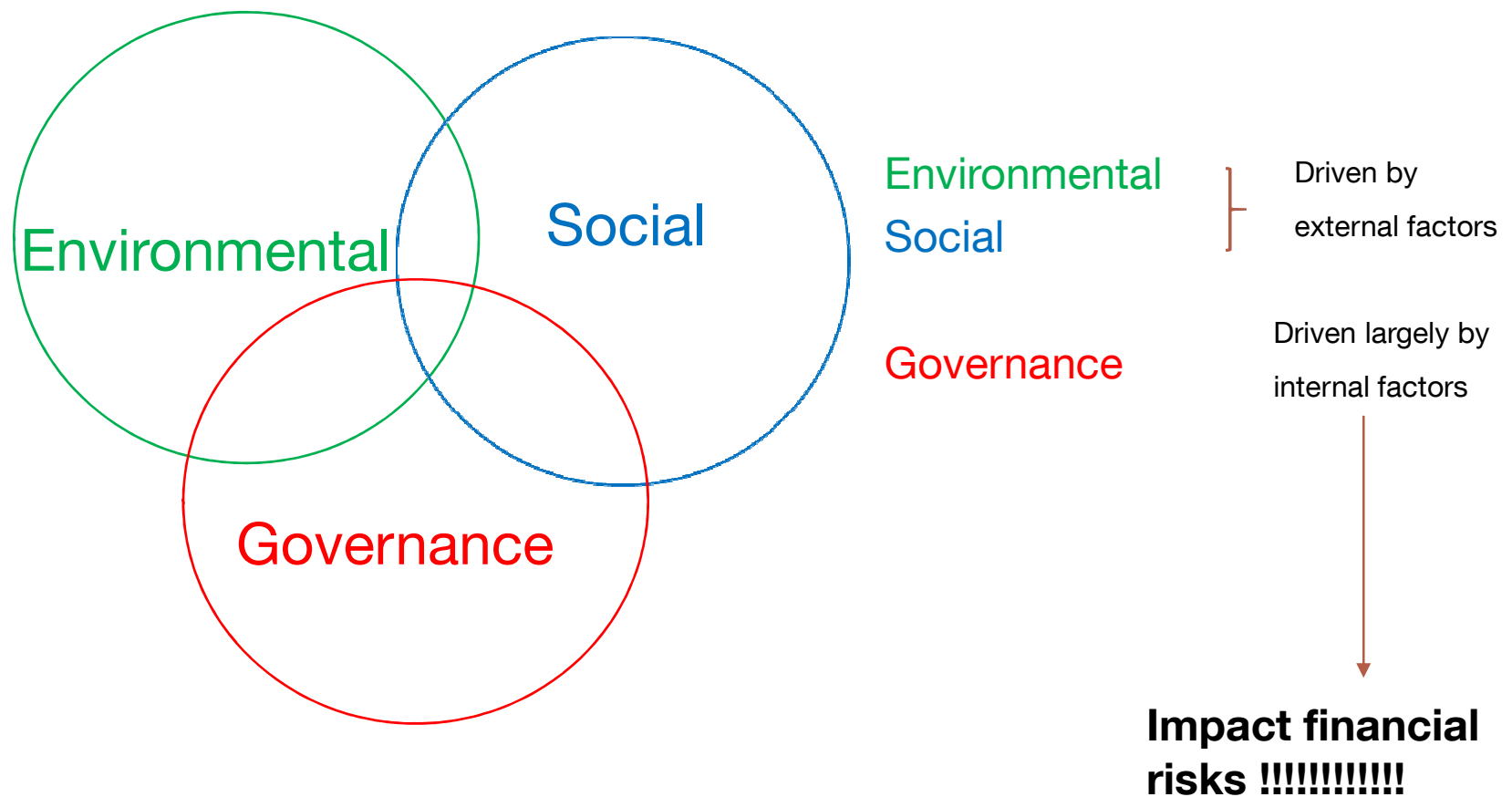
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## OUTLINE

- **Understanding ESG**
- **ESG as risk factor and its management (Regulator)**
- **ESG could impact on asset risk; capital and profitability**



- **Rating companies diverge on ESG** (*Berg, Koelbel and Rigodon, 2019*)

- The extent of the definition of ESG when no single set of definitions has become universally accepted

- The ESG ratings /Sustainability Ratings: Differences

- ✓ *Scope of the selection of different sets of categories/aspects of **E S G***

>50%

divergence



- ✓ *Measurement divergence of categories/aspects*

- ✓ *Relative weight of the importance of the categories*

- **Three components of ESG could be highly interconnected**

*Recent public safety power “preemptive” shutoffs of electrical utilities in California due to the large wildfires caused by the very hot “diablo” winds*

- **Governance:** Corporate behaviour → Long term **key** contributor to bank credit strength
  - Economic Incentives / Deterrant: Regulatory monitoring (prohibitions/limitations) / penalties/fines or Litigation
- **Social:** Banks interaction with the society at large
  - Economic Incentives / Deterrant: Regulatory monitoring (prohibitions) or Litigation charges
- **Environmental:** GHEs, biodiversity, pollution
  - Economic Incentives / Deterrant: Prudential regulation under consideration / Litigation charges

# ESG COULD IMPACT ON ASSET RISK; CAPITAL AND PROFITABILITY

Solvency	Environmental	Social	Governance	
Asset quality	✓ Y		✓ Y	Stranded assets Poor risk gov translate into severe asset quality issues
Capital	✓ Y (?)			Green supporting factor / Brown penalizing factor (?)
Profitability	✓ Y	✓ Y	✓ Y	Penalties/litigation charges Asset write down Loss of investment opportunities
Liquidity				
Funding Structure	✓ Y	✓ Y	✓ Y	Funding diversification (Green) Higher premiums

Source: Author's analysis and rating agencies

THANK YOU

