COPERNICUS THEMATIC WORKSHOP

Key expectations for physical risk management by EU banks

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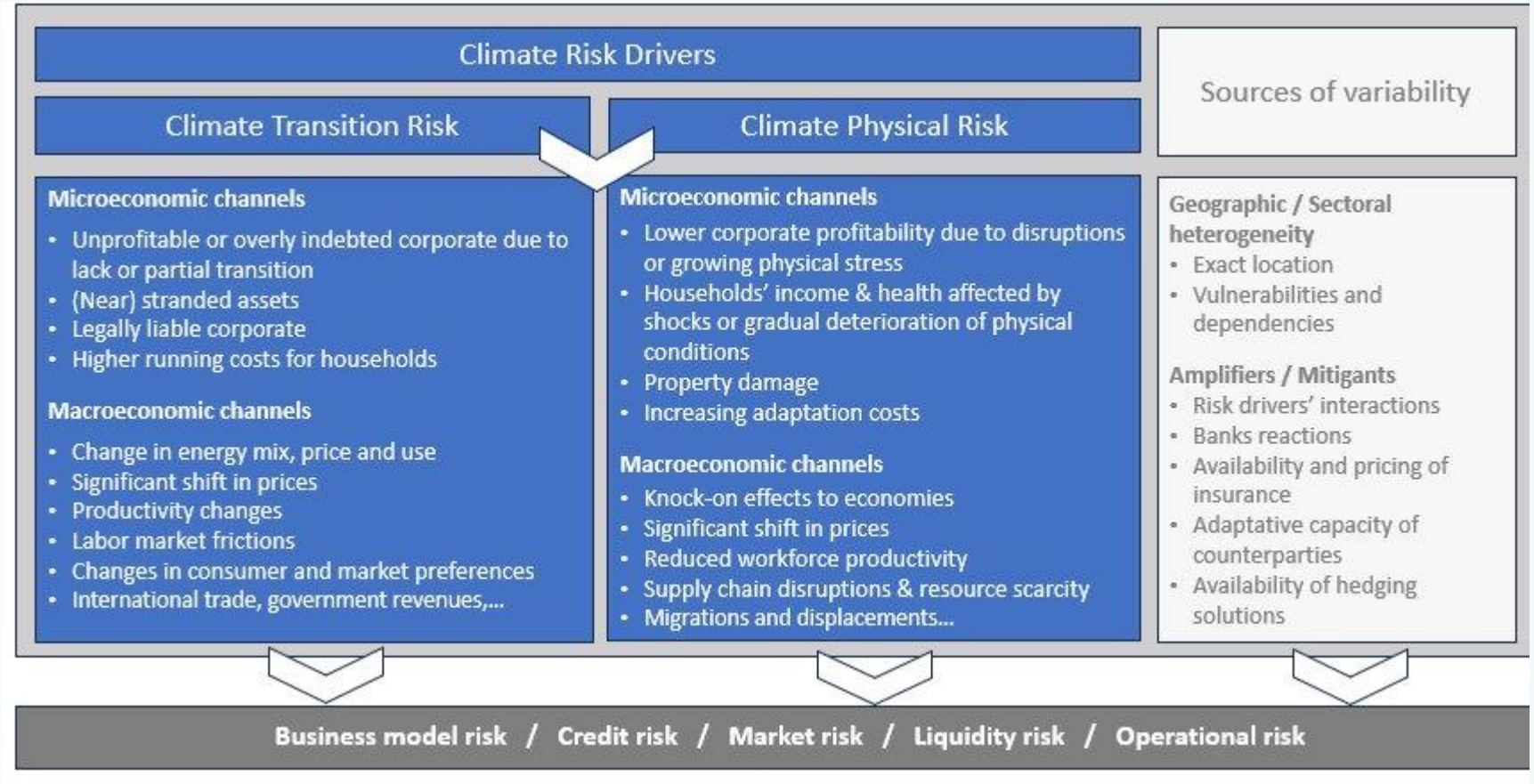
#EUSpace

EU banks face physical risk-related challenges

'physical risk', as part of the environmental risk, means the risk of any negative financial impact on an institution stemming from the current or prospective impact of the physical effects of environmental factors on that institution's counterparties or invested assets (Capital Requirements Regulation, Article 4(1)52f)



EU suffered **€822 billion economic losses 1980-2024** with more than a quarter in last four years (EEA).

Physical risks are expected to continue **intensifying**, even under a net zero scenario.

A sequence of extreme climate events in Europe could reduce its **GDP by almost 5%** (NGFS).

In Western Europe total **investment for adaptation** in 2023 was €13 billion versus estimates needs for the EU at €70 billion/Yr. to 2050.

=> Mounting economic and financial costs translate into higher risks and vulnerabilities + banks role in financing climate resilience

Key banking prudential framework's expectations

EBA Guidelines on the management of ESG risks specify the requirements introduced by the EU banking package
Goal: enhance identification, measurement, management and monitoring of ESG risks to support safety & soundness

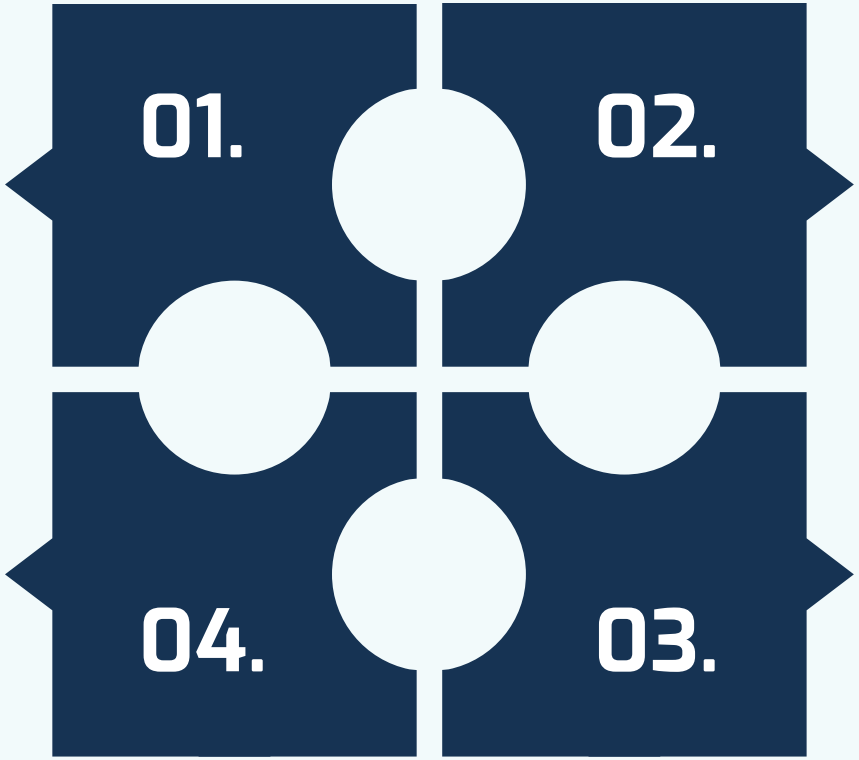
Physical risk aspects to be integrated into the full risk management cycle

Identification

Regular, comprehensive materiality assessment of ESG risks, including physical risk drivers, and their impact on traditional risk types

Monitoring

Monitor ESG risks through internal reporting and early warning indicators, including metric tracking potential concentration risk related to physical risk drivers



Measurement

Use a combination of methods including exposure-based, portfolio-based and scenario-based, considering different time horizons

Management

Embed ESG risks incl. physical risks within risk appetite, internal controls, ICAAP and consider applying a range of tools to actively manage exposure e.g., engagement, financial terms, risk limits etc.

Data sources supporting physical risk assessment

To assess their exposure to physical risk, banks would identify, collect and analyse data that enable them to:

- measure the degree of **vulnerability of their counterparties to environmental hazards** (e.g. temperature-related, wind-related, water-related, solid mass-related hazards)…
- taking into account the **geographical location of key assets** of counterparties (e.g. production sites) and guarantors, or of the **physical collateral** backing the exposures…
- and considering risk-mitigating factors, such as private or public **insurance coverage**.

In doing so, banks should consider and leverage various **data sources**:

- *internally available data*
- ***externally available ESG data*** (incl. for instance earth observation data from public databases & geospatial tools)
- *sustainability information* disclosed by some clients and counterparties under CSRD/ESRS or on a voluntary basis
- *client engagement* and *third-party data*
- *estimates and proxies* where needed to address data gaps

Thank you!

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