7 January 2025

Banking Supervision

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Dear Chief Executive Officer,

Re: MFSA 2023/2024 Thematic Review on the Identification and Management of Climate-Related and Environmental Risks by LSIs in Malta

1.0 Executive summary

In its "Dear CEO letter on Climate-Related and Environmental Risks (C&E risks) preparedness", published on 4 November 2022, the Malta Financial Services Authority (MFSA) set minimum deliverables for 2023 and requested that Less Significant Institutions (LSIs) present their progress by the end of 2023. All LSIs presented their current and planned C&E risks initiatives. In 2024, the MFSA conducted a Thematic Review to assess the LSIs' preparedness to identify and manage these risks.

The objective of this work was to evaluate whether institutions have the necessary frameworks, governance structures and technical instruments to identify, evaluate, and mitigate climate-related and environmental risks across all time horizons to their operations, customers, portfolios, business models, capital and liquidity. The feedback in this letter aims to enhance banks' awareness to potential risks and strengthen their ability to respond effectively to the adverse impact of C&E risks. This is in line with the upcoming implementation of the new banking package.

The 2023/2024 Thematic Review showed that LSIs have made some progress in assessing the materiality of C&E risks and integrating these outcomes into their business and management models. However, Materiality Assessments still require to be better equipped with quantitative and qualitative analysis to identify how C&E risks impact the existing risk categories, such as credit, operational or market risks, among other. As a result, LSIs must further develop their strategy and systems to cater for the management of these risks.

Nevertheless, the MFSA recognises that some institutions have identified practices to address C&E risks, such as developing a risk register and estimating the probability and the severity of physical risk in the short, medium and long term, or by establishing specialised Committees to foster a C&E risks management strategy. These will be outlined further in this letter.

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2.0 Background and Scope

As the financial sector evolves amid growing climate and environmental concerns, managing these risks has become a global priority. The European Commission, the ECB, and the EBA are increasingly promoting resilient and sustainable growth in banking. In December 2022, the MFSA issued a Circular on the "Thematic Review on Climate-Related and Environmental Risks – Less Significant Institutions". In this Circular and in the Authority's 2024 Supervisory Priorities document, in line with the ECB's Supervisory Priorities 2023-2025, the MFSA emphasised the need for institutions to address C&E risks within business strategies, governance, and risk management. In this respect, the Authority is interested to observe progress in core modules such as Materiality Assessment, Business and Environmental Strategy, Governance and Risk Appetite, and the Risk Management Framework.

The Authority assessed the LSIs' preparedness in line with the ECB's expectations (1 to 7) for C&E risks, with a focus on materiality assessment. These expectations guide institutions to evaluate the materiality of climate and environmental risks, integrate them into business strategies, governance, and risk management, embed them in daily operations, establish ongoing monitoring and mitigation strategies, ensure transparency through robust reporting, and actively engage with stakeholders on C&E matters.

C&E risks impact all institutions' activities. Therefore, it is crucial to understand and monitor these risks continuously. Equipped with a strong infrastructure for ongoing monitoring, banks can assess impacts on prudential risk, adapt strategies, and implement governance and mitigation measures to ensure long-term resilience.

This assessment, based on a structured questionnaire aligned with the ECB's guidance, the Authority's "Dear CEO Letter on Climate-Related and Environmental Risks Preparedness," as well as supervisory interactions with the banks, took into account the LSIs' size, nature, and complexity. This self-assessment allowed banks to document their implementation plans, actions, key metrics, and progress in managing climate-related and environmental risks.

3.0 Outcomes of the C&E risks Thematic Review – Industry findings

The Thematic Review findings indicate gaps in the Maltese LSIs alignment with the ECB expectations. Specifically, banks **need to generally enhance their Materiality Assessment** to better identify and monitor the evolution of C&E risk drivers that may impact institutions over the short, medium and long term. The Authority recommends that banks formulate **clear, actionable plans** to align their strategic objectives with climate and environmental considerations. **Governance structures** incorporating C&E risks are becoming more common, with various solutions in place. However, further development is needed, particularly in **integrating these risks into remuneration policies and within the Three Lines Model**. Strengthening governance frameworks is essential to ensure robust oversight and accountability of C&E risks.

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The Thematic Review underscores the need for banks to enhance their preparedness in managing climate and environmental risks. Compliance with the European banking package, along with adherence to ECB's expectations, is essential for building a resilient and sustainable financial sector. We encourage banks to leverage the findings of this review to strengthen their frameworks and ensure long-term sustainability and resilience.

i. Materiality Assessment [1]

a. C&E Risk Materiality Assessments

The MFSA reviewed the materiality assessments submitted by LSIs. These revealed significant **deficiencies in identifying, quantifying, and evaluating C&E related risks and connecting these to prudential risks through transmission channels**. While nearly all banks have acknowledged the importance of C&E risks along their business planning horizon, many of their materiality assessments lack **depth and comprehensiveness**.

b. Identifying Risk Drivers and Transmission Channels

A primary area of focus is the **identification of risk drivers and their connection to prudential risks through transmission channels**. Effective materiality assessment requires banks to:

- **Map all potential C&E risk drivers**, in terms of physical (such as extreme weather events), environmental (such as rising sea levels or crop failures), and transition-related (such as regulatory changes or shifts in market sentiment) risks, and assess their severity and plausibility across multiple time horizons (short, medium and long term).
- **Identify transmission channels that clearly articulate how C&E risks impact prudential risks**, including credit, operational, and market risks, via their counterparties and invested assets. We noticed that banks face difficulties in identifying clear causal links between physical and transition risks and their impact on prudential risks. For example, in assessing credit risk, banks should account for how climate events, such as floods, may impair collateral value, or how regulatory shifts could destabilise borrowers, particularly those in carbon-intensive sectors. However, many banks fail to map these causal relationships thoroughly, leaving significant blind spots in their assessment of C&E risks on credit portfolios. This limitation restricts banks' ability to accurately quantify potential impacts and develop effective risk management strategies.
- Set **clear thresholds to determine when a risk driver becomes material** across short, medium, and long-term horizons, allowing banks to proactively identify and respond to evolving risks over time. In some cases, banks have deemed certain C&E risks immaterial without providing a substantiated basis for this conclusion. Where justifications exist, they often fail to reflect robust data and comprehensive scenario planning, leading to potentially misleading conclusions about the impact of C&E risks.

[1] Guidelines for "Materiality Assessment":
- CRD VI: Articles 73, 74 and 76(1) transposed into BR/12
- EBA/GL/2021/05: paragraphs 30, 78, 152, 153 and 184 transposed into BR/24: paragraph 28, 100, 172, 173 and 204

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c. The Integration of Qualitative and Quantitative Metrics within the Materiality Assessment

Findings indicate that many banks present deficiencies in relation to the following items:

a) Banks should undertake a **comprehensive quantitative and qualitative assessment** of the materiality of C&E risks. This involves analysing how these risk drivers affect prudential risks, focusing on their impact through various transmission channels.

b) The **data used in these assessments is frequently lacking in relevance or depth, failing to capture the full spectrum of risks**. Moreover, the assessments often neglect longer-term implications, limiting time horizons to immediate or near-term impacts, which does not align with ECB expectations for a forward-looking, comprehensive approach.

ii. Business Environment and Strategy (BES) [2]

The Authority has identified significant shortcomings in **how institutions monitor, strategize, and respond to climate and environmental risks**. While banks increasingly recognise the importance of these risks, many are not fully meeting regulatory expectations in three critical areas:

a. Monitoring of Climate-related and Environmental Risk Impact on Business Environment

Many institutions **lack a structured approach to assessing the impact of climate change and environmental degradation on their business environment**, including the macroeconomic and competitive landscape. Sound BES practices require banks to **analyse how shifts in exogenous factors** like energy prices, economic growth patterns, and inflation—often influenced by climate policies—may impact their operations and profitability. Additionally, **observing how competitors respond**, including innovations in green financing and shifts in investment portfolios, provides valuable insights into potential changes in market dynamics.

However, many banks do not systematically monitor these broader trends or assess their implications over different time horizons. This gap restricts their ability to proactively adapt to potential regulatory shifts, market changes, and competitive pressures stemming from climate-related risks.

[2] Guidelines for "Business environment and strategy":
- CRD VI: Articles 73, 74 (1) as applicable transposed into BR/12
- EBA/GL/2021/05: paragraphs 22, 30, 32, 145, 152 and 155 transposed into BR/24: paragraph 21, 28, 30, 165, 172 and 175
- EBA/GL/2014/13: paragraphs 64 and 65 transposed into BR/12 – Appendix 3
- EBA/GL/2018/04: paragraphs 30 and 72 transposed into BR/26: paragraph 17 and 15

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b. Translating Climate-related and Environmental Strategies into KPIs

One critical shortcoming identified is banks' **failure to translate climate-related and environmental strategies into relevant KPIs linked to clear, actionable targets with specific timelines**. For KPIs to be effective, **they should follow a three-layer approach, covering country, sector, and portfolio levels**, and should directly monitor risk exposures and progress toward climate-related goals.

However, many banks still use **KPIs that lack relevance, often focusing on internal goals** (e.g., paper-use reduction) instead of actual climate-related and environmental risk exposures. To be meaningful and actionable, **KPIs must have clearly defined goals and time frames**—such as reducing carbon intensity in lending portfolios by a certain percentage over a specific period from a disclosed baseline, increasing the share of green assets, or reducing exposure to high-risk sectors. Additionally, these **KPIs need to cascade down to portfolios and products**, **allowing for effective monitoring** and steering towards climate targets. Without such alignment, KPIs lack relevance and do not provide the insights needed to manage climate risks effectively.

c. Forward-Looking Resilience Strategies

Another common gap is in **implementing forward-looking strategies to ensure business model resilience** to C&E risks. A robust framework should **include scenario analysis and stress testing** to evaluate the banks' resilience under varying climate scenarios and to guide strategic adjustments as risks evolve. Banks need to establish a system to monitor KPIs in real-time and **set thresholds that signal when risks become material.** This will allow banks to adjust strategies promptly as new risks or regulatory requirements arise. Additionally, setting specific targets for these scenarios provides clarity on what constitutes adequate resilience under various climate scenarios.

However, most institutions **lack such dynamic approaches, relying instead on static strategies that do not account for emerging risks**. This limitation is compounded by the absence of continuous monitoring infrastructure for tracking climate risk indicators, preventing banks from timely adjustments based on evolving data.

iii. Governance and Risk Appetite[3]

a. Management body and organisational structure

Some Maltese banks have made progress in enhancing their organisational structures by establishing dedicated ESG Committees to oversee Climate-related and Environmental risks. However, **the majority**

[3]Guidelines for "Governance and Risk Appetite":

- CRD VI: Articles 74, 76 and 91 transposed into BR/12
- EBA/GL/2021/05: paragraphs 8, 19, 22-24, 28, 30, 32, 34, 42, 64, 68, 94, 95, 147, 154, 155, 161, 172, 177, 191, 209 transposed into BR/24: paragraph 8, 14(a), 21, 22, 23, 26, 28, 30, 32, 40, 80, 90, 114, 115, 167, 174, 175, 181, 192, 197, 211 and 229
- EBA/GL/2021/06 transposed into BR/12: Appendix 1
- EBA/GL/2018/03: paragraph 100 and Section 5.8 transposed into BR/12: paragraph 37 and BR/24 paragraph 181, 245 – 250
- EBA/GL/2021/04 transposed into BR/21

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of the banks have not assigned specific roles within these Committees or defined the corresponding duties and responsibilities, leading to unclear reporting lines and lack of concrete information gathering. Appointing specific roles with the Three Lines Model is necessary for developing consistent data collation and aggregation, and to formulate action plans amongst the Board and Committees.

b. Data and reporting

Furthermore, many institutions **need to develop a robust data infrastructure to effectively collect and maintain up-to-date C&E risk data**. Internal policies and procedures need to properly incorporate C&E risk data and include analysis that demonstrate the outcomes of assessing their impact on all material portfolios. Overall, banks have limited analysis and supporting information regarding the integration of C&E risk data into their governance framework. This data is essential for ongoing monitoring of banks' exposures and the implementation of effective escalation procedures.

c. Remuneration

The Authority also noted that **almost no banks have incorporated KPIs and KRIs related to C&E risks in their remuneration policies**. This connection is necessary to encourage behaviour aligned with C&E objectives and must be further developed by cascading down the KPIs and KRIs. Aligning incentives with C&E goals is necessary to promote climate-conscious behaviour.

d. Risk Appetite

Integrating C&E risks into the RAS is crucial for identifying the key factors that could impact business portfolios. The Authority has observed that the majority of banks are **not effectively managing these risks, as they fail to define specific KRIs within their RAS** that are critical. Enhanced monitoring measures must be implemented to improve the management and oversight of these KRIs.

iv. Risk Management Framework[4]

a. Incorporation of C&E risks into the risk management framework:

Most Maltese LSIs are **lagging in incorporating C&E risks into their Risk Management Frameworks**, with only a few institutions taking substantial steps in this area. Institutions must provide detailed analysis of their risk exposure data to support the implementation of appropriate measures. They need to identify specific risks directly impacting their operations and exposure levels. This includes integrating C&E risks into their frameworks and implementing corresponding action plans. Without these steps, the management of C&E risks remains insufficient, creating the impression that their significance is not being adequately assessed.

[4] Guidelines for "Risk management framework":
- CRD VI: Articles 73, 74 and 76 transposed into BR/12
- EBA/GL/2021/05: paragraphs 151-154 transposed into BR/24: paragraph 171-174
- EBA/GL/2020/06: paragraph 59 transposed into BR/28 paragraph 10(c)
- EBA/GL/2018/04: paragraphs 30 and 72 transposed into BR/26: paragraph 15 and 17

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b. Identification of risk drivers:

Generally, banks have defined a **high-level, limited list of risk drivers, primarily on qualitative assessments**. This approach is insufficient for effective management and monitoring of C&E risks. Furthermore, as most institutions rely minimally on proxies and assumptions when data availability is limited, their ability to identify C&E risks remains constrained.

c. Mitigation measures

The analysis of **mitigation measures is significantly lacking and must be addressed to prevent negative impacts**. Institutions are generally not demonstrating sufficient efforts to manage the effects that risks may pose on their business portfolios. Mitigation efforts are not adequately reflected in the policies and reports submitted to the Authority. Most banks rely primarily on insurance as a key mitigation measure. However, this approach is not considered sustainable due to the potential for increased premiums in the near future, driven by the severity and likelihood of adverse climate events.

d. Risk quantification

While there is general awareness of C&E risks, **most banks made only limited updates to internal policies, procedures and risk management processes, failing to thoroughly assess and quantify C&E risk exposures**. As result, Key Performance Indicators (KPIs) and Key Risk Indicators (KRIs) are not actively monitored at the portfolio or institutional level, which undermines risk assessments. This lack of integration raises doubts about the banks' ability to implement effective mitigation measures or allocate capital as a buffer for unforeseen events.

e. Incorporation of risks within the bank's capital plans

With few exceptions, most banks do not allocate capital to climate-related or environmental risks, nor have they developed mitigation strategies to reduce the impact on capital, liquidity, and business model sustainability. The lack of consideration for capital adequacy is a common red flag across the market. Institutions generally fail to address investments in capital to effectively manage C&E risks and implement appropriate action plans to control this area.

However, some noteworthy findings among Maltese institutions include the facts that:

- Some banks use external data providers to assess risks in bond portfolios or country exposure.
- A few banks have developed C&E risk dashboards for monitoring and communication among stakeholders.
- Some institutions conduct stress testing to evaluate the short, medium, and long-term impacts of various C&E risk drivers.

Closing Remarks

Banks are expected to prioritise their preparedness to identify, manage, monitor and mitigate C&E risks. As both physical and transition risks become more tangible, the financial impacts of C&E risks are increasingly evident, extending beyond reputational damage. Boards must integrate potential C&E risks into their strategic assessments to safeguard business continuity and foster sustainable growth.

In preparation for the implementation of the Capital Requirements Directive VI ("CRD 6") and the upcoming EBA Guidelines on the Management of ESG Risks (EBA/CP/2024/02), banks are strongly encouraged to adopt a more comprehensive approach to integrating C&E risks across all risk categories and within their overall business model to ensure alignment with evolving regulatory expectations.

Despite some progress, many institutions appear to still be struggling with effectively identifying and monitoring C&E risk drivers, especially in **understanding their impact, both quantitative and qualitative, across all time horizons, and how these risks will affect business model and prudential risk categories** (such as credit risk, operational risk, liquidity risk, market risk, etc.).

Integrating C&E risks into **internal reporting workflows and aligning risk management processes** with business strategies are critical steps in this transition, as institutions cannot rely solely on insurance coverage to guarantee the long-term resilience.

The Authority encourages the **development of an internal Risk Register and taxonomy** in line with Sustainable Finance Disclosure Regulation[5] and the EU taxonomy [6]to enhance monitoring and proactive actions in in the integration of C&E related risks.

Additionally, banks face **heightened litigation and reputational risks if they fail to meet their climate and environmental strategy commitments or mislead with their environmental, social, and governance (ESG) disclosures**. The importance of accurate and transparent ESG reporting cannot be overstated, as missteps in this area can lead to severe legal and reputational consequences. As regulatory scrutiny intensifies, banks must prioritise the integration of climate risks to protect their interests and maintain stakeholder trust.

Advances in **data collection and aggregation are essential for supporting effective climate and environmental risk management**. Banks must overcome challenges in data quality and availability to ensure proper climate risk management and regulatory reporting. These developments underscore the urgency for banks to swiftly adapt and enhance their strategies to mitigate climate- and environmental-related risks as regulatory expectations evolve.

[5] Regulation (EU) 2019/2088
[6] Regulation (EU) 2020/852

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Currently, gaps are evident in LSI's alignment to the ECB's expectations in relation to the management of C&E risks. LSIs face the same risks and potential balance sheet impacts as larger institutions, as C&E risk drivers are not tied to an institution's size. Furthermore, larger banks often benefit from a more diversified business model and a wider international presence, which can provide additional resilience against these risks.

4.0 Way forward

Maltese LSIs are required to enhance their **Materiality Assessments**, ensuring robust links between risk drivers and prudential risk categories. Furthermore, LSIs should develop a forward-looking strategy with specific, measurable targets to adapt their business models to address emerging environmental challenges effectively. Strengthening **Internal Governance and the Risk Management Framework** are also critical, with institutions expected to demonstrate clear leadership in defining the risks they are prepared to accept and those they aim to mitigate.

Following its assessment, the MFSA has determined that all banks in Malta need to:

1. Conduct a **comprehensive gap analysis** to evaluate their readiness against the findings present in this letter and broadly, against the ECB expectations.

2. Develop a **remediation plan** approved by the Board of Directors outlining specific, actionable measures with defined timelines for implementation.

These deliverables (including documents and other information used in the plan) should clearly reference each individual item in this letter, specifying how each deliverable addresses the corresponding item from the letter. It is also recommended to apply this approach in relation to the ECB's expectations.

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To ensure accountability and progress, the MFSA requires each bank's CEO to provide these deliverables by the **end of June 2025**, and present the bank's gap analysis and remediation plan and the actions undertaken throughout the year to the Authority.

Yours Sincerely,
Malta Financial Services Authority

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