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Zagreb, 2 December 2021

TO ALL LESS SIGNIFICANT SUPERVISED ENTITIES

Attention of: Management Board

Subject: Supervisory expectations regarding the identification and management of environmental risks

Dear Sir/Dear Madam,

In order to maintain an adequate level of resilience to the negative effects of environmental, social and governance risks (hereinafter referred to as 'ESG risks'), credit institutions are expected to be able to systematically identify, measure and manage ESG risks, prioritising environmental risks and working towards other sustainability factors as methodologies and tools for assessment develop.

Environmental risks as part of ESG risks are becoming increasingly more important for credit institutions' operations, and, considering their different characteristics in comparison to traditional risk factors to which the banking system is exposed, due to uncertainty and time horizon in which they can materialise, such risks command special attention of the banking system. Therefore, on 27 November 2020, the European Central Bank (hereinafter referred to as 'ECB') published the **Guide on climate-related and environmental risks** (hereinafter referred to as 'Guide'), in which it specified 13 supervisory expectations relating to the management of climate-related and environmental risks regarding significant supervised entities. The Guide is available in the Croatian language on the website of the ECB at the following link:

<https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.202011finalguideonclimate-relatedandenvironmentalrisks~58213f6564.hr.pdf>.

It is noteworthy that the Guide uses two terms 'climate-related' and 'environmental' risk which are in this Circular joined under the umbrella of a single term: 'environmental risk'.

In order to ensure a consistent and balanced treatment among supervised entities, less significant credit institutions may use the said Guide as good practice for risk management. Regardless of the fact that the regulatory framework is still under development, the Croatian National Bank (hereinafter referred to as 'CNB') expects all credit institutions to take a proactive approach in including these risks in their management policies and defining of their business strategies.

Aiming to achieve harmonised implementation we provide the following definitions:

- a) **'environmental risk'** means the risk of losses that stem from any negative financial impact on the credit institution due to the current or prospective impacts of environmental factors on counterparties or invested assets of the credit institution, including factors related to the transition to the following environmental objectives: climate change mitigation, climate change adaptation, sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control and protection and restoration of biodiversity and ecosystems; environmental risk includes physical risk and transition risk;
- b) **'physical risk'**, as part of the overall environmental risk, means the risk of any losses stemming from any negative financial impact on the credit institution due to current or prospective impacts

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- of the physical effects of environmental factors (e.g. extreme weather events and gradual climate change) on counterparties or invested assets of the credit institution;
- c) **'transition risk'**, as part of the overall environmental risk, means the risk of any losses stemming from any negative financial impact on the credit institution due to current or prospective impacts of the transition of business activity or sector to an environmentally sustainable economy on counterparties or invested assets of the credit institution.

Physical and transition risk drivers impact economic activities, which in turn impact the financial system. This impact can occur directly (through, for example, lower corporate profitability or the devaluation of assets) or indirectly (through macro-financial changes). These risks also affect the resilience of a credit institution's business model over the medium and long term, and predominantly of those credit institutions with business models that are reliant on sectors and markets which are particularly vulnerable to environmental risks.

In view of the above, **the CNB has from less significant institutions:**

- 1) **expectations regarding their business model and strategy** – when formulating their overall business strategy and making strategic and business decisions to take into account how environmental risks affect their business environment in the short, medium and long term;
- 2) **expectations regarding their governance and risk appetite** – when formulating their risk management framework to include environmental risks in the risk appetite framework and within their organisational structure clearly assign responsibilities for the management of environmental risks at all levels (three lines of defence model);
- 3) **expectations relating to their risk management** – to include environmental risks in their risk management framework as drivers of existing categories of risk (e.g. credit, reputational, market, liquidity risk) and identify and quantify these risks within their overall process of ensuring capital adequacy; and
- 4) **expectations relating to disclosure** – to disclose relevant information and key metrics on material environmental risks.

These expectations are based on the existing regulatory framework which envisages prudent and proportionate risk management, while credit institutions are expected to, on the basis of the proportionality principle and depending on the materiality of environmental risks they are or might be exposed to, gradually adjust their strategies and policies in order to ensure sound management of these risks. The CNB stresses that when adjusting their strategies and policies regarding the identification, measurement and monitoring of environmental risks credit institutions should take into account the nature, scale and complexity of their operations and the risks they are exposed to.

The Croatian National Bank shall assess the implementation of this Circular in the course of supervisory assessment.

In addition, annexed to this Circular is a questionnaire for self-assessment of harmonisation with the listed expectations as a first step in the adjustment to new supervisory expectations. The self-assessment questionnaire shall be provided to credit institutions in electronic form at request which should be submitted to the following e-mail address: bonitetna.regulativa@hnb.hr. The completed self-assessment questionnaire should be delivered via e-mail by 30 June 2022 to the e-mail address bonitetna.regulativa@hnb.hr with an indication 'Questionnaire on environmental risks'.

Kind regards,

Boris Vujčić
Governor