National Bank of Ukraine

Sustainable Finance Development Policy

September 2024

NBU’s ESG policy needs revision

- The Sustainable Finance Development Policy until 2025 (hereinafter referred to as the “Policy”), approved at the end of 2021, needs to be revised and updated due to:
  - ✓ suspension of the Policy’s measures amid russia’s full-scale war against Ukraine
  - ✓ the Policy’s inconsistency with current EU acquis
  - ✓ the Policy’s inability to meet new challenges facing the financial community and the NBU as the sector’s conditions change
- The effectiveness and speed of ESG processes depend on efforts by multiple authorities, including the government.
- As part of the Ukraine Facility, Ukraine should soon integrate ESG elements into reforms in energy, agriculture, and SME policy, and take action for green transition (transition hereinafter).
- The financial sector’s role in sustainable transition processes, such as proper management of ESG risks, is key and will be strengthened as Ukraine progresses towards EU accession.
- ESG aspects will be implemented with regard to realities of full-scale russian invasion, This implies focus on green and inclusive economic recovery, as well as gradual introduction of requirements to financial institutions in view of the system’s capacities.
- Special focus will be put on measures to ensure social justice and inclusion, primarily aimed at war veterans and other persons that have suffered from war.
- The proposed action plan will make it possible to improve the quality of ESG risk management in the financial sector and will help draft an updated Sustainable Finance Development Policy.

ESG: a comprehensive approach to sustainable, ethical, and responsible business

ESG components

E (Environmental)	• Awareness of the environment, responsible use of resources, protection of the environment to reduce one's climate footprint.
S (Social)	• Establishing ethical relations with society: employees, customers, business partners, local communities. • Ensuring proper working conditions and fair pay, inclusiveness of employees and clients, interaction with communities, satisfaction of needs and protection of consumer rights, fair competition and market behavior.
G (Governance)	• Ensuring that an adequate and effective management system is in place that facilitates components E and S. • Ensuring that sustainable development goals are met amid the transition to a low-carbon economy model.

ESG Risk Matrix: a benchmark for economic agents' ESG policies

ESG Risk Matrix (see next slides for details)

<table>
<tr><th rowspan="3">Agent</th><th colspan="3">Effects of risks' materialization</th><th rowspan="3">Measures to mitigate risks and their consequences, and to use opportunities (G)</th></tr>
<tr><th colspan="2">Environmental (G)</th><th rowspan="2">Social (S)</th></tr>
<tr><th>Physical risks</th><th>Transition risks</th></tr>
<tr><td>Financial regulators</td><td colspan="3" rowspan="2">Identification of risks in each economic agent's line of business</td><td rowspan="2">Steps to mitigate risks</td></tr>
<tr><td>Financial institutions</td></tr>
</table>

- Every group of economic agents faces a unique set of ESG risks and must develop specific ESG solutions and sustainable development policies.
- ESG Risk Matrix presents these specifics and the fallout from the materialization of E and S risks for each type of agents, and shows ways to mitigate these risks and unlock opportunities via the G component.
- Special processes and necessary regulations are already in place for proper governance (G) in financial institutions. Governance at the NBU is also adequate. So, focus has shifted away from analysis of G risks towards effective management of E and S risks.
- For some economic agents (banks, regulators), ESG risks arise both from the agents' activities as standalone economic units and from the presence or absence of the agents' impact on other entities. This feature is highlighted in the table.

ESG Risk Matrix: financial sector’s role

<table>
<tr><th rowspan="3">Participants</th><th colspan="3">Effects of risks’ materialization</th><th rowspan="3">Measures to mitigate risks and their consequences, and to use opportunities (G)</th></tr>
<tr><th colspan="2">Environmental (G)</th><th rowspan="2">Social (S)</th></tr>
<tr><th>Physical</th><th>Transition</th></tr>
<tr><td rowspan="2">Financial institutions</td>
<td>▪ Loss of assets due to natural disasters
▪ Business continuity disruptions and reputational risks
▪ Rising financial risks as adverse events for clients occur
▪ Loss of inclusiveness of service provision
▪ Growth in insurance payments as insured events materialize (for insurers)</td>
<td>▪ Inability to do business due to failure to adjust to new conditions
▪ Loss of income from doing business
▪ Deterioration of asset quality
▪ Additional costs</td>
<td>▪ Inability to do business due to failure to adjust to new conditions
▪ Loss of income from and/or profitability of doing business
▪ Staff turnover because of inadequate working conditions
▪ Creditor’s loss of market position and income as a result of inadequate pay and working conditions
▪ Noncompliance with service provision inclusiveness (equality of access) principles
▪ Reputational losses</td>
<td rowspan="2">▪ Presence of an ESG risk management policy (including an exception list), its implementation into the risk management system (at stage one, with three lines of defense)
▪ Effective information exchange with the borrower for disclosure by the financial institution of portfolio data and other info (uniform questionnaires)
▪ Proper assessment of clients’ ESG profile and of the impact of lending on their ESG profile
▪ Assessment of the carbon footprint from own activities, and setting goals to reduce the portfolio’s carbon footprint
▪ Supporting clients and providing recommendations for ESG compliance purposes
▪ Prevention of greenwashing practices
▪ Publication of emissions data (Sustainability Reports or annual integrated reports and other reporting that discloses greenhouse gas data)
▪ Staff training
▪ Anti-corruption, anti-fraud measures
▪ Proper management, corporate culture
▪ Performance evaluation and reward system with reference to ESG issues</td></tr>
<tr><td colspan="3">▪ Risks of loss of liquidity and capital, threats to solvency</td></tr>
</table>

The burgundy color marks the measures that the participants take towards themselves/their activities.

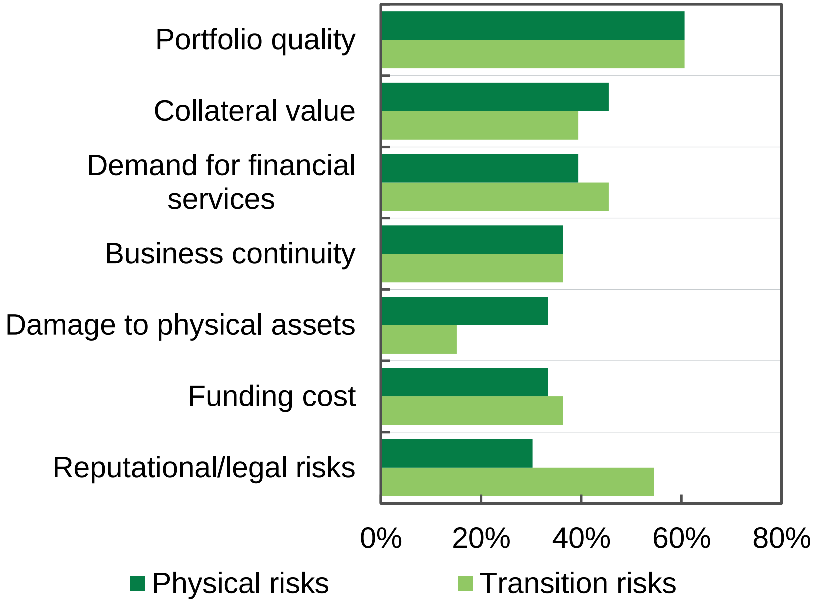
ESG Risk Matrix: financial regulators’ role

Participants	Effects of risks’ materialization			Measures to mitigate risks and their consequences, and to use opportunities (G)
	Environmental (G)		Social (S)	
	Physical	Transition		
Financial regulators	▪ Loss and of assets and scarcity of resources due to natural disasters ▪ Loss of contact with some regulated financial institutions due to disruptions to the their activities	▪ Inadequate discharge of duties by regulators due to the financial sector’s failure to face new conditions ▪ Inadequate performance of functions by the sector because of insufficient control over compliance with ESG risk requirements ▪ The sector’s inadequate involvement in compliance with ESG policies	▪ Staff turnover due to improper working conditions ▪ Impossibility of carrying out activities in line with new conditions	▪ Designing the ESG Policy for the financial sector in coordination with the plans of other regulators/authorities ▪ Promoting disclosure of ESG risks/policies by the sector ▪ Encouraging the sector to offer products with better conditions – sustainable products – to spur ESG development ▪ Methodology guidelines for inclusive provision of financial services ▪ Implementation of the National Financial Literacy Development Strategy until 2030 ▪ Establishing own ESG risk profile and own ESG risk management policy ▪ Drafting documents to support inclusion, in particular an action plan for reintegration, adaptation, and assistance to war veterans, and support of other socially vulnerable groups at the NBU
	▪ Risks to financial stability			

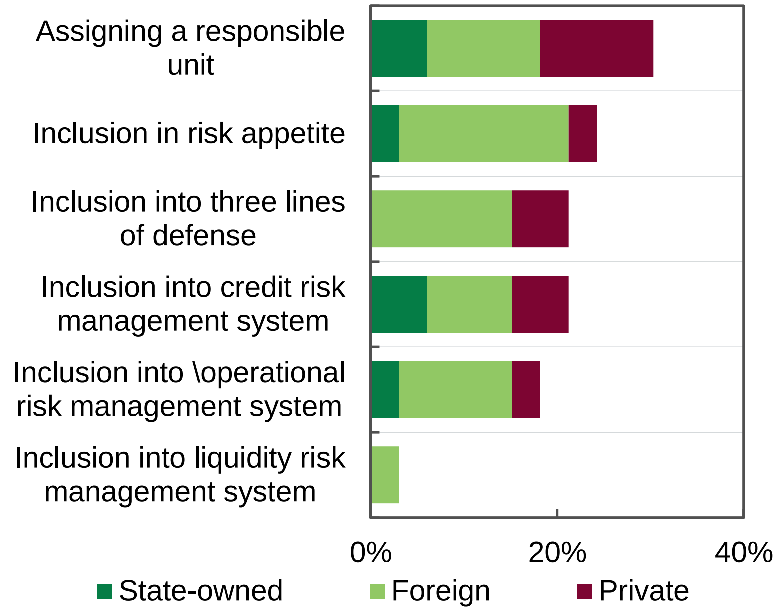
The burgundy color marks the measures that the participants take towards themselves/their activities (i.e. as a market participant rather than a regulator).

Banks are only starting to manage climate risks

Share of surveyed banks that noted the impact of climate risks on the specific aspects of their activities



Share of surveyed banks that reported inclusion of climate risks into their risk management system



Source: banks' survey.

- NBU polled 33 banks about their approaches to climate risk management. Almost three quarters of respondents noted that climate change has impact on their activity.
- However, just a third of polled banks have advanced in managing of these risks, integrated them into risk management system, primarily as a part of credit an operational risks.
- Integration of climate risks into credit risk assessment remains weak: the risks do not affect loan terms or parameters of credit risk assessment.

NBU’s measures to support sustainable finance

Steps by the NBU to manage and minimize ESG risks should be taken in two areas:

1. As a standalone economic agent, the NBU faces ESG risks as a result of its own economic activity

Implementation through the development and introduction of the **NBU Internal Policy**, which will shape the NBU’s work as an organization

2. The financial sector and the NBU as its regulator can play a significant role in mitigating ESG risks in the financial and real sectors if financial sector participants develop their own ESG policies, do explanatory work with clients/consumers, and help them understand and identify ESG risks and favorable lending/financing conditions

Implementation through the development and introduction of the **NBU’s ESG Risk Management Policy for Financial Institutions** across the financial sector

Stages of Policy development and implementation for the sector

Stage	Stage description	Expected outcome
I	Development of a single glossary of terms, unification of bank client questionnaires on the risk profile, systematization of bank experiences on drafting ESG policies/strategies.	Approval of an ESG policy White Paper that has been agreed with the financial sector.
II	Development and approval of ESG risk management guidelines, disclosure of ESG risk data by financial institutions.	Approval of the financial sector ESG Policy.
III	Extension of ESG risk management and ESG risk data disclosure guidelines to include the nonbank financial sector. ESG risk assessment at the financial system and economy level. Supervision of Policy's implementation.	ESG Policy's implementation.

- Steps to draft and implement the NBU's ESG Policy towards sector should be taken in stages.
- The ESG policy White Paper should outline the current state of the sector's ESG risk management, its vision going forward, as well as a detailed plan of regulatory actions to transition the sector to its envisaged state and an intermediate stage before Policy is drafted.