In collaboration with

Université du Luxembourg



BRIDGING THE GAP

FROM RESEARCH TO PRACTICE

This series translates the ADA Chair's research into actionable insights for inclusive finance professionals.
More at adaimpact.lu

ESG RISK MANAGEMENT UNDER EU BANKING REGULATION – TOWARDS SUSTAINABILITY RISK MANAGEMENT

An examination of the EU's latest ESG-related banking regulation raises questions over its ability to effectively improve financial risk management and the potential blurring of financial regulation with a broader policy agenda of climate neutrality.

BACKGROUND AND STUDY RATIONALE

ESG considerations for financial sustainability

In response to the EU's strengthened ambitions to achieve climate neutrality by 2050, EU banking regulation has introduced enhanced environmental, social and governance (ESG) requirements into risk management frameworks of credit institutions. This development forms part of the broader EU Sustainable Finance Framework (EUSFF), which aims to channel private investment towards sustainable activities and finance the EU's transition towards a low-carbon economy.

Several provisions of the revised Capital Requirements Directive (CRD)[1] and Regulation (CRR) cover ESG considerations and responsibilities, which together constitute and define an **ESG risk management framework**. This regulatory framework came into force in January 2026 and **requires credit institutions to identify, manage, monitor and report risks,** including ESG risks, which they are or may be exposed to over short, medium and long-term horizons.

For credit institutions, ESG risks are part of a broader range of sustainability risks that may negatively impact their counterparties or their own invested assets, thereby affecting their balance sheet and profitability. This perspective includes risks faced by clients of credit institutions and the institutions themselves, such as the risk of lending to an entity in a flood-prone area or investing in activities and/or geographies with weak governance structures.

Strictly speaking, ESG risks do not include adverse sustainability impacts related to negative externalities, unless these impacts materialise as a financial risk for the bank itself – for example, if a fossil-based activity becomes unprofitable due to tighter decarbonisation policies. Under EU law, however, including the EUSFF, **both sustainability risks and adverse sustainability impacts are recognised as key dimensions for the sustainability-oriented transformation of the EU's economy,** a legal concept known as double materiality. Since the CRD and CRR act as sector-specific legislation under the EUSFF, their alignment with the wider sustainable finance framework comes into question.

RESEARCH QUESTION AND METHODOLOGY

Unpicking the ESG risk management framework

The authors of the study conducted a qualitative analysis of the EU's regulatory ESG risk management framework embedded in the CRD and CRR. The analysis assessed legal provisions against financial risk management and sustainable finance principles, framing them within the broader legal context of the EUSFF and drawing from the European Banking Authority guidelines. The assessment focused on the **distinction between ESG risks and adverse sustainability impacts,** and exposed resulting implications for credit institutions and the sector's overall competitiveness.

©ADA asbl 2026 · ADAimpact.lu
39 rue Glesener L-1631 Luxembourg

[1] CRD IV (Directive 2013/36/EU) is the consolidated, currently applicable version of the legislation. This article covers additional provisions inserted by CRD VI (Directive (EU) 2024/1619) amending CRD IV.

RESULTS

From ESG risk management to mitigating ESG adverse impacts

The legal analysis of both CRD and CRR highlights the expansion of credit institutions' risk management frameworks to incorporate ESG risks. **ESG risks** are not seen as a separate non-financial risk category but are explicitly **recognised as potential sources of financial risk.**

The framework is based on three pillars:

1. ESG risk management,
2. ESG risk stress testing,
3. ESG strategy, operationalised through Business Transition Plans.

As part of this risk management process, ESG risks threatening financial stability must be systematically identified so that they can be measured, managed, and monitored over time.

The framework introduces a demanding long-term perspective, requiring risk modelling to consider horizons of up to ten years, longer than those typically used in financial risk management. **The authors question the relevance and accuracy of such models,** given changing interest rates, innovation and geopolitical uncertainty, as well as limited reliable data and causal evidence.

Importantly, scenario planning and transition plans are expected to align with the EU's environmental policy ambitions. Banks' transition plans must ensure the compatibility of their business models with the transition to a sustainable economy and include climate targets for 2030, with subsequent targets up to 2050. At the same time, **the extent to which banks are mandated to report and/or limit adverse sustainability impacts (as opposed to risks) remains ambiguous.** The conflation of ESG risk management and adverse ESG impact mitigation constitutes a fundamental weakness of ESG-related banking regulation.

LOOKING AHEAD

Policy implications for market competitiveness

The authors support integrating ESG risks into banking regulation but warn against inconsistencies within the EU sustainable finance landscape. In practice, they recommend to:

1. **Focus ESG regulation on financial sustainability**

   Banks should manage ESG risks where they affect their profitability and resilience, while achieving specific environmental outcomes should be considered separately, as in other parts of the EUSFF.

2. **Allow flexibility in risk management methodologies**

   Finding causality between "carbonised" assets and ESG implications is not a straightforward task, and the decarbonisation fostered by ESG-related regulation may lead to risk concentrations in other areas that lead to bigger risks for banks overall, as well as systemic risks. Regulators should thus avoid imposing untested, standardised models that encourage sector-wide herding and capital misallocation. Institutions should retain methodological flexibility, while improved sustainability disclosures strengthen data quality over time.

3. **Protect competitiveness**

   Additional ESG risk management and reporting will raise internal refinancing costs for financial institutions. Economic activities may thus shift outside the EU, affecting the global competitiveness of EU financial markets.

About the academic authors

Julia Sinnig is an Assistant Professor in Commercial Law at the University of Luxembourg. Dirk A. Zetzsche is a Professor in Financial Law and holder of the ADA Chair in Financial Law (Inclusive Finance) at the University of Luxembourg.

Access to the full academic paper

This document was produced by ADA, based on the academic paper by the authors mentioned above.

With the support of LUXEMBOURG AID & DEVELOPMENT

In collaboration with Université du Luxembourg

©ADA asbl 2026 · ADAimpact.lu
39 rue Glesener L-1631 Luxembourg
October 2026