25 September 2020

EBF response to the ECB consultation on the Guide on Climate related and Environmental Risks

Key General consideration

1) Timing

- **Frontloading upcoming regulation should be avoided** . Implementation efforts and investments have to be devoted to 'final' solutions, not moving targets still subject to upcoming discussions with regulator - -importance to at least await clarification of EBA on definitions and future policy direction.
- **Adequate implementation time.** The ECB expectations will need to be considered across a number of internal processes (governance, material risk assessment, Risk appetite, Stress testing etc.) and adequate time to address and implement these requirements in will be needed.

- **Phased approach** should be introduced to avoid unlevel playing field and timelines being driven by a 'regulatory competition' among supervisory entities, rather than a rational calendar.

Avoiding frontloading upcoming regulation

- It is necessary to align the calendar of supervisors with that of regulators to **avoid inconsistencies and eliminate uncertainties** as to the date of implementation of the proposed proposals. The calendar proposed by the ECB will front run and lead to inconsistencies with the regulatory agenda mandated for the EBA in CRR2 and potentially CRR3 changes.
- The Guide refers to existing regulation as a legal basis used by supervisors in their review. We are still awaiting the EBA to fulfil its mandate given by CRR 2 to include ESG factors in SREP and reflect on the prudential treatment of sustainable finance assets. Such roadmap includes several mandates spread from 2020 until 2025. The inclusion of ESG factors is a new regulation field, meaning that both regulators and banks should benefit from appropriate time to integrate such requirements.
- We understand the supervisory wish to start the supervisory dialogue as soon as possible after finalizing the Guidelines to identify the gaps. While we do not propose to wait till 2024, we do believe that as a minimum, **the regulatory clarification should be awaited** (EBA report expected to be issued in June 2021 that is expected to provide clarification on definitions as we as future policy direction).
- Moreover, the EBA Guidelines on loan origination explicitly referenced in the Guide, were finalized in last May and will be applicable by 30/06/2021 with a transitional arrangement of up to 3 years.

Considering time necessary for implementation, lack of data and methodologies under developments

- The ECB will need to recognize that banks are not in a position to comply with the expectations by the end of 2020, and potentially not by 2021 either – especially considering **significant gaps re climate related client data** (e.g. GHG emissions ,asset level information such as location data, asset type) to assess exposure to transition and physical risk, and information about client transition strategies, resilience and adaptation plans, etc.), **and a lack of common understanding of what metrics are to be used.**

- Besides, this Guide is published at a time which is delicate for banks due to Covid-19. The regulatory measures introduced so far by European banks including the ECB provided welcome relief for banks. The return-to-normal should be progressive, meaning that the supervisory dialogue should be lead with greater flexibility.

- As partially acknowledged in the Guide, it has to be understood that a full and complete integration of climate-related and environmental risks into banks risk management framework **will need robust quantification methodologies**, which are still at a very early stage. The ECB document reinforces the idea that institutions must take a forward- looking approach to considering climate/environmental risk, but the risk management discipline is still in progress (there is a lack of comprehensive tools and methodologies). **For this reason, a flexible phasing approach is needed**. The different expectations should be prioritized to help banks in the definition of roadmaps.

<u>Introducing phase in approach and level playing field</u>

- We understood that a certain degree of flexibility and prioritization /phasing will be possible within each JST teams and agree that flexibility will be needed considering specific market circumstances or business models. The phasing should be allowed by the ECB in the Guidelines with the following components:

  (i) **the nature of climate and environmental risks** (climate, environment, biodiversity, other): each bank should be allowed to choose its priorities based on its business specificities:

  (ii) **The risk typology**: we believe that it is not realistic for banks to address initially all the different aspects (credit, operational, market and liquidity risks.) Each bank should be allowed to explain the prioritization it has retained.

  (iii) **the scope of clients** (large corporates; mortgages and real estate/ SMEs / financial institutions): as already stated, banks will not be able to implement all ECB's expectations at the same time; even more that data availability differs from one client segment to the others. Although banks goal is to cover the full scope of client segments, each bank will need time and adopt a sequencing on the implementation based on its own calendar and constraints.

- **The ECB should promote a phase-in approach starting by a supervisory dialogue in 2022, with transitional arrangements in the implementation calendar for the different risk drivers:**

- working towards compliance by June 2022, to comply with the expected regulatory requirements by the EBA (mandatory ESG disclosure in P3).
- Interim period (Dec-20 to Jun-22) could be considered a "phase-in period",
- It is recognized that qualitative assessment of transition risks related to climate change is the starting point and inclusion of quantitative assessment might come at a later stage (climate stress tests organized by EBA and competent authorities such as ACPR / PRA should help improving methodologies). Therefore, quantitative impact assessment of physical risk quantification and other environmental risks (biodiversity for example) have yet to be reflected. This will justify extending deadlines for application of this Guide and introduction of a phased approach based on the nature of environmental risks(by order of importance : climate, biodiversity, other), and the risk typology by order of importance : credit & operational risk, market, and liquidity risk)
- and the scope of clients (by order of importance : large corporates, SMEs / retail / financial institutions, reflecting the different stages of maturities in terms of data/methodologies/ and practices.

2) Principle based approach vs detailed requirements

We favour a principle-based guideline. However, if a detailed expectations system is chosen, it is essential that the requirements are then defined from the outset and aligned with the approach of regulators, so that supervised entities can work with certainty towards meeting the expectations. In addition, it is necessary to avoid late introduction of detailed requirements or standardization (e.g. close to the implementation deadlines or when firms have already invested in developing their own approaches)

3) Level Playing Field and proportionality for Less Significant Institutions

(i) Intra-EU Application:

These guidelines only apply to those significant credit institutions supervised by the SSM, leading to the risk of competitive advantage for banks that are not under its oversight in the Eurozone, non-Eurozone banks and non-regulated banks. It is of paramount importance **to preserve level playing field within the EU**. In this sense, it is important that the national authorities (NCAs) when supervising the Less Significant Entities, keep the proportional approach as aligned as possible with the SSM guidelines, adapting it as necessary, ensuring that in general there is the same approach in the EU to monitoring climate and environmental risks in the sector.

The EBF will be happy to **facilitate the dialogue with LSI banks** in order to identify areas where proportionality matters in order to clearly identify minimum requirements for small and not complex banks (a bank will always has the possibility to opt in to more demanding requirements) to be applied by NCAs. Among those areas reporting is an issue but also all the requirements regarding governance, risk management and other internal process are extremely challenging for LSI.

It **is also important that the guide also applies to any inbound companies** (incl. inbound financial institutions, hedge funds, and asset managers) and their global activities. This should be explicitly stated to ensure a level playing field.

(ii) EU – rest of the world

Some SSM Banks have developed part of their activities in jurisdictions located outside the European Union where, in some cases, they already have to meet local requirements and guidance similar to that which the ECB is proposing to implement with this new guidance.

We are concerned that the Guide would result, for those credit institutions with subsidiaries in non-Eurozone area, into a **double regulatory and reporting framework**. Detailed specifications in the ECB guidance will not be helpful if they are not aligned with regulations or guidelines in other jurisdictions that have different approaches

4) Proportionality in terms of different assets

Alongside the risk materiality concept already introduced in the Guide, better proportionality should also be included. Different types of asset classes should not be treated in a one-fits-it-all-approach. **Exposure size and tenor should be considered as factors**, as it will not be feasible to assess every counterparty on a loan or trading book. A high- risk sector approach should be followed, at least in the early stages of implementation. Besides, regarding specificities of environmental risks, banks should be allowed to **reflect in the requirements the geographic maturity regarding environmental risks** (e.g. differentiated decarbonisation horizons for jurisdictions). We suggest the Guide clearly provides for a proportionality principle as it is allowed in the EBA Guidelines.

5) Data availability and verification

One of the biggest challenges in developing the climate change risk management framework relates to data. The data gap that we are facing is critical and the availability of comparable ESG data is fundamental. Moreover, banks need a better disclosure from their clients to properly manage climate related risk, but first of all we need to define a limited set **of Key Performance Indicators (KPIs) and Key Risk indicators (KRI) common for all banks**, in order to grant a level playing field. The identification of these KRIs and KPIs should be evaluated in terms of **relevance, feasibility and phasing** of their implementation and should be consistent with other key initiatives on the matters. Clarity on KRIs and KPIs is important in order for any institution to assess the state of their IT systems to capture and store the required granular data points needed to derive each KRI.

Available, reliable, and standardized E&S and non-E&S data on clients (clients assets localization in the case of physical risks for example) are a pre-requisite for the development of quantification methodologies. Banks should therefore not be expected to have such methodologies until the NFRD, which will for instance support availability of such data, is finalized and companies have reported using it.

Banks can have limited (or no) liability on some of the information which is provided by their customers. Specifically, it is impossible for the banks to prove the veracity of some of their customer's climate-related data (levels of emissions, DNSH, etc.). NFRD and other regulation should include the mechanisms to make the information of the companies' reliable enough, based on their own review/audit processes, but **not putting the burden of the proof on the subsequent users** of these information.

6) The level of application

The Guide **should remain at consolidated level**, and only if relevant, some perimeters might be explored by carrying out deep dives rather than applying the Guide at a sub-consolidated level

7) Governance and the need for a holistic approach

Governance around climate-related and environment financial risks should rely on existing general provision/ expectations.

We consider it **not appropriate to duplicate general risk managements requirements** of the EBA guidelines on internal governance for the purpose of climate and climate related risks. This would create redundancies and makes the regulatory rulebook even more complex. Banks should indeed have a flexibility to either set up a dedicated governance structure for climate risk or incorporate into existing governance structures. We would like to ask the ECB to **confirm that the guide doesn't request a separate governance structure for climate risk but that existing governance may incorporate climate risk** (e.g. existing Risk Management Committee of the Board should have oversight of climate risks along with other risks.

The management of climate-related and environmental risks will be covered by existing risk management practices. Requirements which are risk-transversal such as governance for instance should remain holistic, implying that there should not be requirements which will introduce parallel framework.

We would recommend streamlining the entire guide and focus better on requirements where climate and climate related risks differ from other risk drivers or risk types.

8) Climate and environmental risks as driver of existing risk categories, or a separate risk category

As stated in chapter 3.1. – 3.2. **climate and environmental risks are being understood as a risk driver that effects known risk categories like credit, market, and operational risk**. A large majority of banks share this opinion. We also understood this is the opinion of EBA and think that it is the right way to consider this kind of risk as a risk driver and not a separate risk category, although few banks are likely to consider climate risk as a separate risk. However, the application is not consistently reflected throughout the guide. Rather many of the expectations of the ECB are formulated in such a way that climate and environmental risks could be considered as a separate risk type. The wording in the guide should be adjusted in that sense. Examples for that are the materiality assessment of climate risks (exp. 1.1), KPI-set (exp. 2.2.), limits for climate risks (exp. 4.1) etc.

In addition to that, institutions should be required **to address and report this kind of risk driver only if it is material at the level of the known risk categories**. It should thereby be allowed that an institution that identifies climate and environmental risks as being relevant for its credit risk exposure but not for its market risk exposure applies the requirements only in regard to credit risk but not in regard to market risk.

It is true that climate change indeed will likely be relevant for all institutions. However, the actual risk exposure will depend on geographic location and the business model of an institution. Therefore, it should be possible that **not all the expectations of the ECB guide will be relevant for an institution**.

9) Cross effects between physical and transition risk still need better understanding through scenario analyses

Cross effects between physical and transition risk exist and banks and their customers need to look further into this area. These will take some time to work out, since everything is a guesstimate, scientific knowledge is evolving. **The purpose of scenario analysis is to understand exactly that - different possible future outcomes.**

10) Symmetric approach

ESG factors can have both, positive and negative impact as risk mitigators or risk drivers. Indeed, the impact of adaptation to climate-related risks can materialize in two directions. Some customers might be negatively affected by the consequences of their transition risk (restrictions imposed by regulation, market preference changes, etc.); but, conversely, there will be companies that might be benefitted by exactly the same factors (because of their current business model, or a successful transformation path which is aligned with upcoming regulation and market sentiment, etc.)

The guidelines include several references to the negative impacts on the risk profile (and parameters) of customers that might be most affected by climate-related risks. For example:

- Worsen shadow PDs for higher risk customers [section 6.2, box 8]
- Penalties to the assets projected to have the highest level of environmental impact [section 6.1, box 7]
- Expectation for entities to identify and adjust ratings of borrowers exposed to increased climate-related risks [section 6.2, expectation 8.2]
- Companies losing customers because of the change in preferences [section 4.1, expectation 1.1]
- Capital charges for clients classified in risk categories subject to adverse ESG impact [section 6.3, box 10]
- Potential losses from changes in consumer preferences and customer sentiment [section 3.2]
-

While the ESG factors as risk drivers are considered in the Guidelines, **the ECB should explicitly acknowledge that climate & environmental factors can have both positive and negative effects, potentially acting as risk mitigators or risk drivers**. Additionally, ECB should refrain to promote or apply any negative implication on capital of these factors until the EBA finalizes its assessment

11) Common set of relevant KPIs

Financial institutions should **develop relevant common KPIs, eventually for some of them shared with the non-financial industry to ensure comparability in disclosures and cascaded down to individual business lines and portfolios.** As long as the revised NFRD is not finalized, banks should be allowed to use their own KPIs for reporting and disclosure purposes.

Please see also our response to the Commission; s Consultation on Article 8 of the Taxonomy Regulation. https://www.ebf.eu/sustainable-finance/ecs-inception-impact-assessment-on-art-8-ebf-feedback/

12) Use of illustrative examples

Although the boxes explaining existing practices within banks provide useful views, they should remain **explicitly examples as bank specificities should also be considered**. Therefore, we suggest such mention to be included in the Guide as to ensure a harmonized understanding of inspection teams. Although, at the paragraph 2.1, it is stated that boxes are examples (the observed practices shared throughout this document, described in the boxes, merely serve as a means of illustration and are not necessarily replicable, nor do they necessarily meet all supervisory expectations), it should be made clear that **inspection teams cannot use such examples as the supervisory "general rule".**