

DISCUSSION PAPER ON MANAGEMENT AND SUPERVISION OF ESG RISKS FOR CREDIT INSTITUTIONS AND INVESTMENT FIRMS

EBF Response

2 February 2021

General considerations

Banks are increasingly active in the assessment of climate risks, which can in particular in the medium and long term impact their clients' viability and solvency, thus profitability and risk of bank's itself. While we support any 'efforts to proactively incorporate ESG factors into risk management as risk drivers we believe it **should not substitute necessary public policy actions** for economic actors to change their economic behaviour and decrease overall risk in the economy and foster sustainable economic development. Banks can accompany and will complement the EU policy, but they cannot substitute potential lack of political action.

Challenges and data availability

The EBA paper is balanced, comprehensive and shows a good understanding of the challenges to incorporate ESG factors into risk management. **ESG risks are difficult to quantify** and this applies also to climate related risk factors even if they could be assessed with external data and specific variables (such as the carbon price) that can be used to build models and "long-term climate related scenario analysis.

The **time horizon** of ESG impacts is longer than the regular time horizon for strategic planning, the prudential timeframe' and the supervisory time horizon and there are also other methodological challenges to integrate these risk divers in the risk management framework. There are many **uncertainties about the actual effects**, which is partly due

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to the absence of historical data and the need to develop forward looking approaches and methodologies.

Over time the EBA expectations should be achievable, but there are still challenges. One of the biggest one relates to **availability of reliable, audited, adequate, recent, and low-cost data**. Improved availability of corporate and retail data will be a key factor for adequate banks' risk management, for the development of new financial products and for helping consumer and businesses to transition. Available, reliable, and standardized data are a prerequisite for the development of quantification methodologies. Although the developments in non-financial reporting and related legislation (like the EU non-financial reporting directive) have accelerated in the last few years, reporting and data availability is not yet at the level of the financial reporting. Recent disclosure legislation, such as the EU Taxonomy and SFDR, do provide more granular guidelines for disclosure. However, these are primarily focused on green assets for which data availability and quality might improve, but this is not the case for other non-green assets.

Phase in approach

A phase-in approach is necessary to progressively include those risks in bank's frameworks and organize the internal processes, systems, organization, and retrieve appropriate data. The EBA should lead the process, establishing the definition of the ESG factors, as well as a practicable calendar, since not all of the expectations and considerations in the activities and key processes can be achieved at the same time. The role expected for the Risk Management Function and for the other internal control functions require a full definition of the ESG factors, prior to adapting the internal regulation and/or define skills or assign roles and responsibilities.

At this moment it is also not yet possible to have many quantitative **indicators indicating financial implications of ESG factors**, certainly not over all sectors or portfolios over the short, medium and long term. On a client level in certain cases there is more quantitative information, depending on its reporting and transparency, on specific indicators. That does not mean there is a methodology that quantitatively estimates what those data points mean in terms of future (financial) risks for that client. This remains a works in progress for banks as well as supervisors. The EBA should provide flexibility and encourage alternative methods, metrics, and indicators in the short term to bring all ideas forward.

A clear distinction should be established between acute and non-predictable events (black swan), and long-term trends, which have different impacts on prudential risks. In view of the challenges the discussion paper so aptly describes, regulatory requirements should be introduced step-by-step. It is important to let good practices first evolve and be tested before introducing hard and fast rules. The inclusion of these risks in the **SREP** process should focus during the first years on **qualitative aspects** and seek a "supervisor-supervised" dialogue/mutual learning **before having quantitative implications**.

As the December 2020 Interim Study prepared by BlackRock on the development of tools and mechanisms for the integration of environmental, social and governance (ESG) factors into the EU banking prudential framework shows, the incorporation of ESG risks into supervisory review processes will be a widespread priority across EU supervisors over the next 3 years. However, the focus seems to be primarily on the 'E' pillar (page 115 of the Report).

Based on the above, as an industry we would welcome a phasing-in approach which for instance could start with the 'E' pillar (with Climate risk drivers as a priority) and either business model (Element 1) or Internal Governance and Risk Management (Element 2) and would gradually introduce further 'pieces' as methodologies becomes more mature and key outstanding issues are solved

Clarity on the objectives

We believe there is a lot of confusion in the current discussion on why and how to deal with ESG risks. This is partly because the objectives are often not clear or at least not transparent. One goal could be to achieve **or support the Paris climate targets** and thus reach greenhouse gas emission neutrality in 2050. Another might be **to ensure the solvency of institutions**. A further goal could be to **identify the vulnerabilities of an institution** and draw conclusions about long-term options for action. These objectives, which are certainly not intended to be exhaustive, **require different time horizons** and different indicators and methodologies.

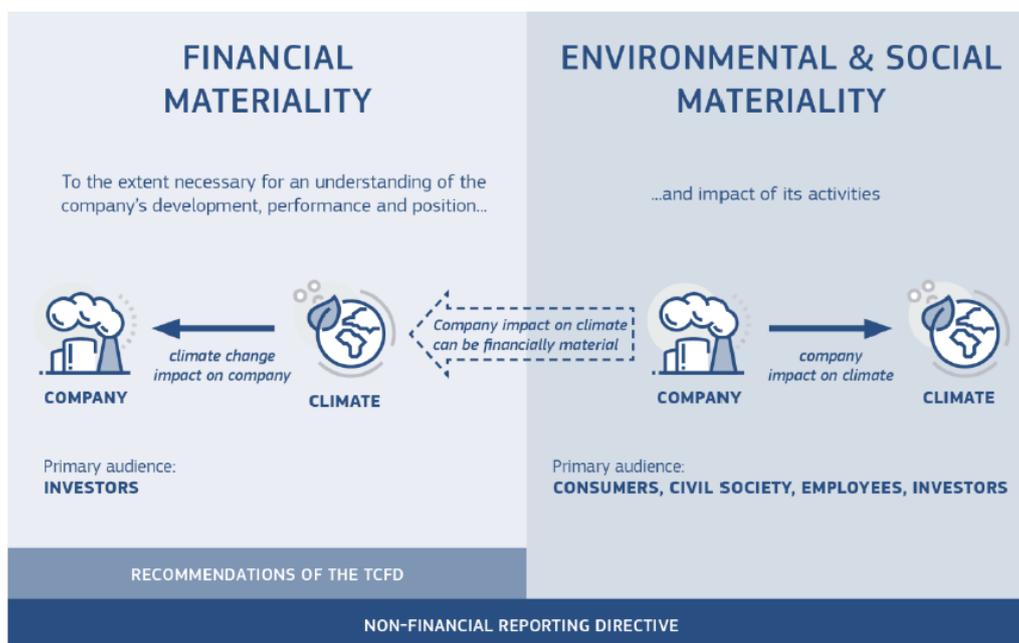
Without absolute clarity on which goals are being pursued and what the focus is on, it will be impossible to develop sound methods and measures. A greenhouse gas neutral portfolio, for example can be safely assumed to have a low ESG risk. But that says nothing about the actual risk of this portfolio. Even a portfolio that is 100% green may be very high risk. And, in particular, even a portfolio that is 100% taxonomy-compliant will be subject to transition risk. Battery-powered vehicles, for instance, could become obsolete when hydrogen or synthetic fuels are produced in much higher quantities and at lower cost. There are consequently conflicting goals here, which need to be resolved. **That is why the EU Taxonomy is not considered an appropriate tool for ESG Risk Management purposes.**

Double materiality

The NFRD in its 2019 supplement defines environmental and social materiality separately from financial materiality (different from the TCFD framework where only financial materiality is being considered) while EBA definition of materiality includes both aspects without separating them.

For counterparties, in respect to climate, what matters for banks for risk management purposes, is the **financial impact** of the climate on the counterparty and the **financial impact** of the counterparties on climate. This second part is the arrow "*company impact on climate can be financially material*" in the figure below. In other words, when it comes to the impact of counterparties on environment and society, this should be considered in risk management process of bank's **only to the extent they affect the financial statements of the counterparties** (fines, higher production costs etc.).

Figure 1
The double materiality perspective of the Non-Financial Reporting Directive
in the context of reporting climate-related information



* Financial materiality is used here in the broad sense of affecting the value of the company, not just in the sense of affecting financial measures recognised in the financial statements.

https://ec.europa.eu/info/files/190618-climate-related-information-reporting-guidelines_en

Risk horizons

The framework should distinguish between short-term (1-3 years) and medium/long term (3-10 years) risk horizons.

In the **short-term** horizon, the focus should be on the correct **assessment of risks**. ESG factors act as risk drivers and should therefore be considered in the time horizon. This can be achieved qualitatively or quantitatively when accurate methodologies are available.

In the medium/long-term horizon (3 to 10 years), the focus **should be on consistency in approaches**, ensuring that **strategy** of institutions was built considering ESG factors and expected ESG trends in a **qualitative manner**.

Scenario analysis could be a useful tool to feed thought around business strategy, but their results should be used with caution and cannot be used as such as a tool measuring properly institution resilience, given the uncertainty around methodologies and data.

The “**long term horizon needs to be clarified**. We propose to **limit the long term horizon to 10 years, which** already represents a considerable extension of the current 3 to 5 years strategic planning horizon. This time horizon is also compatible with the weighted average life of banks assets. Respective E, S and G risks may also have different time horizons (§155).

Proportionality and materiality of risks

We welcome the inclusion of proportionality principle in the discussion paper, however we are concerned about the linkage done between proportionality principle and the size of institutions in specific paragraphs. We think that **automatically signalling size as the driver for assessing proportionality should be avoided**. The extent to which institutions may be precisely vulnerable to ESG risks varies. It is a function of the institution’s business model, relative size, internal organisation and nature and complexity of its activities in terms of transition risk and geographical location for physical risk. One might look at the markets they operate in (how regulated they are), geographical location as well as their investment strategy (private banking focused, mortgage lending, or an investment fund focused on fossil fuels) as indicators of their vulnerability to ESG risks. Specific vulnerability relates also to the complexity and cost of data and data handling.

We also favour a **risk-based approach**. Considering the **risk profile of the bank, the notion of materiality of ESG risks should be more specifically introduced**, so that institutions identify and tackle ESG risks drivers that are considered material within existing categories of risk.

Definition of ESG risks and factors

We believe the definition of ESG factors is acceptable, especially considering the additional information and explanations provided on what is considered a “factor” and the fact that those factors can **trigger or aggravate the materialization of some risk types** such as credit risk market risk or operational risk (drivers of existing risks). However, the notion of ESG risk does not add clarity. We suggest to explicitly outline that the **ESG risk is not defined as a separate risk category**. A credit risk that is triggered or aggravated by one or several ESG factors does not change the intrinsic nature of the risk type, it remains a credit risk. If it is important to identify situations where credit risk events are triggered or aggravated by ESG factors, they do not become ESG risk events because they are “colored” by ESG factors, they are still credit risk events.

Also inclusion of the word ‘**any**’ will in our opinion end up being an incentive for institutions to focus on backward looking strategies to include any ESG possible risk which might not have been identified at an earlier stage. By changing the word ‘any’ to ‘identifiable’ or ‘foreseeable’ and focusing on materiality, the definition becomes more forward looking and less likely to raise concerns about liabilities as a result of overlooked ESG risks.

Also, the ‘**prospective**’ impact of an ESG factors seems to be a rather ambiguous term in the definition. ESG factors could materialize to ESG risk at some time in the future, but the impact for an institution depends highly on the time horizon or maturity of the exposure in combination with the likelihood of materialization of the risk. It would be

helpful to clarify the meaning of 'prospective' in the definition. Preferable accompanied by a clearly defined forward looking timeframe.

We are also concerned to what extent institutions are responsible for ESG risks (in particular the S &G) when considering the **full value chain** in a company's production cycle. Consequently, we consider the scope of counterparties' risks that banks are able to acknowledge and manage should **be limited**. Considering the inclusion of all potential ESG risks across the value chain of counterparties/companies may lead to diminished access to finance for some companies in transition as banks would try to limit their liability risk.

Finally, the angle of the **negative impacts should be developed in a context where positive impacts are also considered**.

Social and Governance risks

Identifying SG risks of a counterparty is only possible after a thorough due diligence, which is not suitable for all counterparties and all issuers in a portfolio. However, keeping in mind the many and fast regulatory developments with regards to human rights, children's rights and required due diligence at EU level, it could be helpful if the EBA provides more clarity on the next steps or timeline by when it expects progress on governance and social risks.

In relation to specificities associated with the management of governance risks, it is worth recognizing that management/governance factors are an integral component of credit risk assessments and ratings already such that any guidance from EBA is tailored at 'enhancing' without 'double counting' those factors.

Use of indicators

We agree that ESG risks drivers need to be identified through qualitative and quantitative indicators. The non-exhaustive list of ESG indicators provided is an important starting point to obtain information on ESG related issues, and they can form the basis for the development of product offerings, and some banks have considered them as part of product taxonomy development (separate from a risk taxonomy of sectors). **However, most of the indicators are not necessarily suitable for risk management and are difficult to be evaluated and applied, especially outside the EU. That is why we highly appreciate that this list is not prescriptive.**

EU Taxonomy

The EU taxonomy is intended to be used by banks for the categorization of sustainable finance product offering. That is not linked to risk management, although the expectation is that steering towards sustainable product offering will help de-risk portfolios as a company that engages in sustainable activities may be better positioned from a sustainability / reputational risk angle. However there are many other factors that can

unfavorably affect its financial performance (e.g. unbalanced debt/equity structure, poor product offering, etc.).

We appreciate the clarity provided during the public hearing on 26th November, explaining that the **EU taxonomy is not considered as a risk management tool** to avoid any misunderstanding between different stakeholders. For greater clarity, we would be grateful **if this** clarification could also be included in the final report as the EBA remains ambiguous (*green asset ratio* is expected to be included in Pillar III new set of requirements (as indicator for *risk mitigation* purposes)).

Methodologies

The **principle of methodological freedom** should generally be applied in **Pillar 2, which includes the methodological treatment of ESG risks drivers**. It will continue to be the task of supervisors to set an overarching framework. It should be up to each individual institution, however, to design its own risk management strategy. We welcome the EBA's flexibility on the method to be used by institutions. However, this flexibility should be understood as a long-term approach, as choosing a specific methodology has significant investment implications for the development of systems. We therefore encourage the EBA to **maintain this flexibility over time**, or at least, to provide a clear timeline with sufficient early warning for institutions to be able to update the systems and processes accordingly.

Alignment methods

Our understanding on portfolio alignment methods is that this relates more to strategy and business opportunities than to risk management, although we understand that this is a very dynamic topic and the information could be used as a qualitative risk indicator of the companies' transition trends in the medium term. It is important to highlight the heterogeneity in approaches and the difficulties in assessing alignment. It would be interesting to understand whether the regulatory community is planning to use any **external or internal methodology** for analysing the portfolio alignment as an input for prudential regulation, as they mentioned other methodologies without explicitly supporting them. This is a key issue to be able to balance the investment effort in these external methodologies. We are especially concerned about it since experience has demonstrated that the use of external methodologies related to credit risk models has been penalized in a regulatory basis, being the internal developments the preferred options by regulators.

Risk framework methods

Stress testing is particularly challenging, as it requires extensive resources, is connected to a problem of finding a full set of scenarios to cover both probable and rare yet possible outcomes. Climate sensitivity analysis, being a simpler form of integrating climate risks into financial modelling, could be a working solution even for smaller banks, yet there is not enough experience at the market within this method.

We fully agree with the EBA's assessment that methodologies are still in an early form and that they all require a substantial degree of subjective judgement. Banks

are considering other methodologies from external providers, given that for now there is no capacity for most credit institutions to develop this models/methodology in-house.

For this reason, we would welcome clear regulators views on **to which extent the use of external provider methodologies will be acceptable** over the time whether either as a long-term or short-term solution having in consideration that existing limitations to develop in-house methodologies are still going to continue in the coming years.

Exposure methods

While ESG ratings provided by specialized rating agencies are a good way to secure industry-wide, coordinated understanding of ESG risks connected to various counterparties (there is a need for a higher degree of method transparency and consistency by ratings providers for approval of specific ratings by regulators. The risk of investing into external data without being certain they are audited, reliable and they meet regulatory approval is too high in particular for a small institution that will have to rely on internal developments for which many times capacities are lacking.

We would also like to note that use of different ESG ratings providers could led to significant distortion in counterparties ESG risk assessment (due to major differences in methodologies used by providers, and their lack of transparency).

Many ESG ratings are reflective of ES performance and do not actually represent an ESG risk profile, so should be used cautiously when assessing ESG risks.

Integration of ESG factors in modelling and capital planning

We welcome EBA comments on the difficulty to include ESG factors in internal credit models. The events depend on scenarios that are long-term, so they cannot be integrated in the credit models but projected. Historical data cannot predict the future, for which reason they can only be calculated by means of scenario analysis in the future and need new forward-looking approaches and new methodologies given the unprecedented nature of ESG and specifically CC factors and risks.

Banks will have to progressively test relevant ESG factors to complete the gaps in data (including their back testing), methodology, assumptions that have not been established and tested with soundness.

Liquidity and funding

For liquidity and funding, it seems plausible that liquidity and value of assets could be impacted, as well as retail cash flows. These are incorporated in liquidity stress testing, although not explicitly attributed to ESG risks. However, liquidity and funding seem less pressing as the ESG risks drivers are also largely considered to have a longer-term impact while liquidity risk is mainly a short-term risk.

Stress testing

Climate -related scenario analysis is currently considered by banks as an appropriate tool to assess the materiality of ESG risk drivers their impacts on the business model. We welcome the pilot exercises launched by EBA and other supervisors on climate risks assessment. Thanks to fruitful experience and lessons learnt, such exercises pave the way, on both supervisors and institutions' sides, for the development of reliable and robust regulatory and internal methodologies for climate-related scenario analyses.

Forward-looking analyses are good approach for capturing potential impacts of ESG risk drivers, because ESG risk drivers are intrinsically forward-looking in the very long-term. Moreover, climate-related sensitivity analyses outcomes should for the time being primarily focus on ESG-related KPIs, and secondarily on specific financial indicators, in order to focus on the assessment of ESG risk drivers on the business model.

Consequently, such climate-relate scenario analyses should remain clearly differentiated from solvency-related stress testing exercises, which use different methodologies, pursue different objectives, and therefore measure different impacts, based on different indicators.

We welcome recommendation that institutions should leverage on the NGFS scenarios to overcome the modelling challenges on climate risk scenarios. However, it is important to bear in mind that some institutions need to **cover a diversified portfolio** with a lot of sectors/subsectors in different geographies **and that granularity is incomplete** at this moment, and it will take some time for the NGFS to finalize the task.

Similarly, the **use of "multiple scenarios" to assess climate risks should be clarified** to avoid adding further uncertainty and heterogeneity in outcomes across institutions, as for now there is not sufficient accuracy to cover all the sectors and geographies in the different climate scenarios for orderly and disorderly transition pathways and year horizons, among other variables.

We also believe that the EBA 's expectations on **how feasible it is for institutions to have all the relevant data available and reliable** to perform climate stress tests and respond to "a broad range of on-demand requests" could be too far reaching for now.

We would encourage the EBA to properly reference the challenges around data, institutions dependencies' on third parties including customers, data providers, etc, and acknowledge that as these are not standard tests, the same level of data consistency would be difficult to achieve for now.

In addition, it is important to reiterate that we expect that the data quality and availability will gradually improve in the European Union as the reviewed NFRD and other initiatives are implemented, but this will not be the case in many **other jurisdictions** where different institutions operate.

Climate-relate scenario analyses results should therefore only be used qualitatively and not take for capital adequacy or capital allocation.

Pricing

The DP calls on institutions adjust their pricing to reflect also the risks driven from the ESG factors and account for ESG risks in their pricing strategies. This is an important step which needs very careful consideration given that **pricing is already dependent on global market forces**. Any discussion on pricing should

take place only after methodologies to identify, evaluate and manage the ESG risks drivers are well advanced and implemented into ESG risk management frameworks.

More generally on the SREP, considering the level of maturity of quantification methodologies, the focus should for now be **on qualitative approaches**. Especially regarding the long-term resilience of institutions, the **EBA should clarify that a full-fledged financial planning is not expected**.

From a **conceptual point of view, we understand why the time horizon of the supervisory assessment needs to be extended**. The nature of ESG issues, particularly climate-related ones, requires a longer time horizon of business model planning. The regulatory need to assess long-term resilience of credit institutions is also understandable. Benefit lies in looking at a variety of time horizons to manage the impact of climate change as different risks could materialize and inform strategic choices as well as risk appetite setting. Whereas classic stress testing models focus on quantifying the near-term impact that corresponds with the financial planning horizon, we recognize that for climate the impact is predominantly noticeable in the long term (reaching up to 2050).

From a practical point of view, there are a number of obstacles:

- To assess any upcoming ESG risk drivers (beyond 12 months period), we would understand the Competent Authorities have in place additional tools to gather those potential risks, for instance, the climate related scenario analysis where a more forward-looking approach is imbedded
- The reason why the current forward-looking assessment is in practice constrained to about 5 years is that the longer the time horizon, the greater the uncertainty. Extending the time horizon to 10+ years would introduce a significant amount of uncertainty into this assessment. It is difficult to gauge if such an assessment would then lead to credible outcome.
- The key document to assess supervised entities' business models, both the viability ("ability to generate acceptable returns from a supervisory perspective over the next 12 months") as well as sustainability ("ability of an institution to generate acceptable returns from a supervisory perspective over a period of three years") is the strategic/business plan which seldom covers time horizons over 3 years. Therefore, while we see merit in adopting a more forward-looking approach, we would like the EBA to consider the challenge banks might face in striking the right balance between "extending the time horizon" and "making more robust and reliable strategic projections".
- It is important to consider the value of geographic and sectoral diversification in the assessment long term resilience of credit institutions. Some studies suggest that bank lending has remained reasonably resilient in the face of past natural disasters, at least where banks' exposures are relatively diversified across geographic regions. The cross-border transmission of climate-related risks via financial institutions could give rise to diversification, by transferring risks to those best placed to bear them globally. Cross-border bank lending might therefore play

a role in diversifying, rather than amplifying, climate-related risks across a range of lending countries.

- The key hurdle on assessing either of these time horizons is around the access to adequate (historic) data and convergence of methodologies that can support the quantification of the impact. The need for long-term assessments is clear given the fact that loans with a long maturity, such as residential mortgages, that are given today should already be able to withstand a substantial part of the energy transition and/or potentially strong physical effects from climate change. However, the outcomes should obviously be treated cautiously and in a very different way from the more traditional short to medium term assessments. This is clearly an example where banks, regulators and supervisors should team up to collectively determine approaches for this.

Consistency

Lastly, we reiterate that any framework developed by ECB should be consistent with the EBA's framework.

Response to specific questions in the Discussion Paper

Common definitions of ESG factors, ESG risks and their transmission channels (Chapter 4)

1. Please provide details of other relevant frameworks for ESG factors you use.

We recognize the importance of the mentioned international frameworks in the discussion paper but would like to stress that not all the international initiatives do consider ESG risks as financial risks. Therefore, while we support the alignment, we do not believe these should be used as guiding risk frameworks.

There are countless initiatives covering ESG factors and ESG risks and it is important to achieve alignment in the definition of ESG factors and ESG risks. At the same time, as also recognized in the discussion paper, the identified ESG factors and associated risks are likely to evolve over the time, so any policy framework should be flexible enough to address adequately emerging issues in the transition of a sustainable economy.

We would discourage rigidity, too prescriptive a view particularly considering dual materiality. Each institution should be given flexibility to identify the risks in their portfolios and operations and build appropriate processes, structures, and appetite frameworks to manage and mitigate these risks. An institution's regulator can and should apply proportionality depending on the complexity, business activities, product offering and geographic footprint.

In order to identify other relevant frameworks for ESG factors that banks use in addition to those mentioned in the Consultation Paper, please note that banks distinguish between

frameworks that are used systematically in internal policies and frameworks and those used on a case-by-case basis as appropriate.

For example:

1. Frameworks included as reference documents in our internal policies/frameworks, such as:
 - The standards for social and environmental performance and the explanatory notes of the International Finance Corporation (IFC).
 - The United Nations Global Compact, the Universal Declaration of Human Rights; the International Labor Organization Declaration; the Convention on the Rights of the Child; the Rio Declaration on Environment and the United Nations Convention against corruption.
 - Task Force on Climate-related Financial Disclosures (TCFD).
2. Frameworks to be considered case by case, when needed, namely:
 - Sustainability Accounting Standards Board (SASB)
 - Climate Bond Initiative (CBI)
 - ICMA Social Bond Principles (SBP) and Green Bond Principles (GBP).
 - LSTA Green Loan Principles (GLP).

2. Please provide your views on the proposed definition of ESG factors and ESG risks.

Page 26, ¶30: 'ESG factors are environmental, social or governance characteristics that may have a positive or negative impact on the financial performance or solvency of an entity, sovereign or individual.'

Page 28, ¶38 'ESG risks mean the risks of any negative financial impact to the institution stemming from the current or prospective impacts of ESG factors on its counterparties'.

We welcome the recognition that ESG factors may have both, positive and negative impacts, although the paper focuses on negative impact in terms of identification of increased risks.

We believe the definition of ESG factors is acceptable, especially in light of the additional information and explanations provided on what is considered a "factor" and the fact these are considered as drivers of existing risks Triggering or aggravate the materialization of some risk types such as credit risk market risk or operational risk. Considering the ESG Risk, we suggest however to explicitly outline that the ESG risk is not defined as a separate risk category. A credit risk that is triggered or aggravated by one or several ESG factors does not change the intrinsic nature of the risk type, it remains a credit risk. If it is important to identify situations where credit risk events are triggered or aggravated by ESG factors, they do not become ESG risk events because they are "colored" by ESG factors, they are still credit risk events. The term ESG-driven/ ESG-related risk could be a considered as a suitable alternative that is directly associated with established risk categories.

Also, the inclusion of the word **'any'** in the definition of ESG risk will in our opinion end up being an incentive for institutions to focus on backward looking strategies to include any ESG possible risk which might not have been identified at an earlier stage. By changing the word 'any' to 'identifiable' or 'foreseeable', while considering materiality, the definition becomes more forward looking and less likely to raise concerns about liabilities as a result of overlooked ESG risks.

Also, the **'prospective' impact** of an ESG factors seems to be a rather ambiguous term in the definition. ESG factors could materialize to ESG risk at some time in the future, but the impact for an institution depends highly on the time horizon in combination with the likelihood of materialization of the risk. It would be helpful to clarify the meaning of 'prospective' in the definition. Preferable accompanied by a clearly defined forward looking timeframe.

It is important to state that banks could also consider improvement paths of the counterparties that act as a mitigant of the prospective risks of the counterpart.

Double materiality concept

While we support the double materiality concept, we believe it should benefit from further explanation and alignment between different initiatives and supported by guidance. The double materiality is difficult to assess and manage both in environmental & climate (i.e. emissions) and also in "social" risks, especially when considering the full value chain in a company's production cycle. Although larger companies may be better placed to provide limited assurances, for smaller players it is a large burden to expect them to understand the "social" practices of all their suppliers.

At the moment, the high degree of flexibility to determine parameters of materiality makes it almost impossible to compare materiality assessments, its results and as a consequence, the content of reports. Therefore, in general, a principle-based concept about how to conduct a materiality assessment should be introduced.

Given the purpose of prudential supervision, the solvency of individual institutions and thus the reduction of systemic risk to the financial system are the focus of the EBA's Pillar 2 rules. We believe the regime governing ESG risks should focus on an institution's financial risks.

For counterparties, in respect to climate, what matters for banks are the **financial impacts** of the climate on the counterparty (plus the **financial impacts** of the counterparties on climate. In other words when it comes to the iimpact of counterparties on environment and society, this should be considered in risk management process of bank's **only to the extent they affect the financial statements of the counterparties** (fines, higher production costs etc.).

The materiality for banks should be defined as linked to the financial impacts on counterparties only.

Distinction between climate and environmental risks

We welcome that EBA does not artificially distinguish between climate and environmental risks, given overlaps

Liability

We are also concerned to what extent institutions are responsible for social and governance risks when considering the full value chain in a company's production cycle. Consequently, we consider that the scope of counterparties' risks that banks are able to acknowledge and manage should be limited. Considering the inclusion of all potential ESG risks across the value chain of counterparties/companies may result in diminished access to finance for some companies in transition as banks would try to limit their liability risk.

Holistic approach and global perspective

With the aim of moving forward to a more sustainable economy not only at European level, but globally the integration of ESG factors should be done in a holistic way to avoid for instance the improvement of an environmental factor to the detriment of a social factor.

This holistic approach will have to be adapted also to the different jurisdictions and companies operating there. Developing countries are going to face the most significant social and governance risks as far as they have not yet well-integrated sustainability into their objectives and priorities. In this regard, institutions/entities with an international footprint seem to be especially affected, since they are going to be sensitive to the idiosyncrasy of each of the geographies where they operate.

Risk horizons

The framework should **distinguish** short-term (1-3 years) and medium/long term risk horizons (> 3 < 10 years) .

In the short-**term** horizon, the focus should be on the correct **assessment of risks**. ESG factors act as risk drivers and should therefore be considered in the time horizon. This can be achieved qualitatively or quantitatively when accurate methodologies are available.

In the medium/long-term horizon (3 to 10 years), the focus should be on consistency in approaches ensuring that ESG factors and expected ESG trends were considered in the institutions' strategies in a qualitative manner.

The long-term horizon needs to be clarified. We propose to **limit the long-term horizon to 10 years**, which already represents a considerable extension of the current 3 to 5 years strategic planning horizon. This time horizon is **also compatible with the weighted average life of banks assets**. Respective E, S and G risks may also have different time horizons (§155).

Prescriptivity

Lastly, we would like to understand if the EBA poses these definitions as binding, or whether institutions remain to have some room for adjustments given the rapidly developing area. We would discourage rigidity, too prescriptive a view particularly in light

of materiality considerations. Each institution should be given flexibility to identify the risks in their portfolios and operations and build appropriate processes, structures, and appetite frameworks to manage and mitigate these risks. An institution's regulator can and should apply proportionality depending on the complexity, business activities, product offering and geographic footprint.

3. Do you agree that, for the purpose of assessing their inclusion in institutions' and supervisors' practices from a prudential perspective, ESG risks should be approached primarily from the angle of the negative impacts of ESG factors on institutions' counterparties? Please explain why.

Yes, we agree that the greatest impact will be felt through bank counterparties.

In addition, we believe that whenever possible, the angle of the negative impacts should be developed in a context where positive impacts are also considered.

It should also be acknowledged that, when comparing individual companies in individual sectors, a positive assessment of the company's management of these risks will have a positive impact on the risk profile of the financial institution and should also be recognized. This will provide a blended view of the overall risks, and is in line with the treatment of other relevant risk factors (e.g. the value of real estate collateral).

4. Please provide your views on the proposed definitions of transition risks and physical risks included in section 4.3.

Page 30, ¶46: 'Environmental risks are the risks posed by the exposure of institutions to counterparties that may potentially be negatively affected by environmental factors, including factors resulting from the climate change and factors resulting from other environmental degradation.'

In general, we agree with the proposed definition of "Environmental risks", however we consider that the description of environmental factors in paragraph 4.3.1 is too limited to climate change, and it would benefit from the inclusion of other environmental examples that would better link into the definition of Environmental risks in section 4.3.2 that, most correctly, also includes factors like environmental degradation.

Regarding physical risks (point 54): this is explained as physical effects of climate change or other environmental factors, including A) acute physical effects and B) Chronic physical effects. Given that 'other environmental factors' are mentioned, it would make sense if EBA added a category 'C' explaining these other environmental factors. Physical risks are indeed also about environmental degradation (air, water, and land pollution). Hence, we presume that this category is related to environmental degradation, in part as a result of the business of clients/counterparties.

Paragraphs 44 & 45 are very important explanations of the interplay between environmental and climate change factors, and it also indirectly touch on "social" aspects

(in the example, the impact on local communities who could face water shortages driven by excessive industrial use).

Page 33, ¶154: Physical transmission channels/physical risks are the risks posed by the exposure of institutions to counterparties that may potentially be negatively affected by the physical effects of climate change or other environmental factors, including:

- a. acute physical effects, which arise from particular events, especially weather-related events such as storms, floods, fires or heatwaves, that may damage production facilities and disrupt value chains; and**
- b. chronic physical effects, which arise from longer-term trends, such as temperature changes, rising sea levels, reduced water availability, biodiversity loss and changes in land and soil productivity.**

We believe the proposed description of physical risks provides very welcome clarification of the fact that “environmental events other than climate change can drive physical risk”. The provided examples in Box 3 are very important.

Some definitions include specific examples while in other cases more general examples are provided. In this sense, we would suggest taking out the sentence “*that may damage production facilities and disrupt value chains*” as the discussion paper had until now refrained from including examples in the definitions, and we consider that this lack of examples would be the correct approach.

Both ECB and EBA have added “*chronic physical effects, which arise from longer-term trends, such as temperature changes, rising sea levels, reduced water availability, biodiversity loss and changes in land and soil productivity*” to their definition of physical risk.

Banks can currently only assess this in a qualitative way. Quantifying these risks is very difficult as banks do not have data or models to do so. For some risks (biodiversity loss) these models are even more difficult to determine since the impact is probably only indirect on banks.

Other than this, we consider that the proposed definition is acceptable, especially whether the definitions / explanations of environmental factors are also expanded as we suggest in our feedback earlier in this questionnaire.

Page 37, ¶68: Transition transmission channels/transition risks are the risks posed by the exposure of institutions to counterparties that may potentially be negatively affected by the transition to a low-carbon, climate-resilient or environmentally sustainable economy, including:

- climate and environment related policy changes, for example as a result of energy efficiency requirements, carbon-pricing mechanisms that increase the price of fossil fuels, or policies to encourage sustainable use of environmental resources;**

- **technological changes, for example if a technology with a less damaging impact on the climate or the environment replaces a technology that is more damaging, hence making it obsolete;**
- **behavioural changes, for example if the choices of consumers and investors shift towards products and services that are more sustainable; or if difficulties to attract and retain customers, employees, business partners and investors arise when a counterparty has reputation for damaging the climate and the environment.**

With regards to transition and physical risk definition: the way we read this under point 47, all risks are grouped under environmental risks, and physical, transition and liability are named as transmission channels/risks under that. The definition and set up here is a slightly different set up than ECB used in its draft guide, but in the basis, we believe it touches on all the same risks and risk factors. The consistency with the ECB Guide could be clarified.

We believe that the risks mentioned in 59 (a to e) are not transition risks but risk types for which transition to a low carbon and climate-resilient economy can be a driver. The transition risk definition under point 68 makes sense to us, although we would suggest referring to them instead as parameters for classifying, modelling and monitoring the vulnerability to and impact of ESG factors.

Furthermore, applicability of the different transmission channels (physical, transition, and liability) to each of "E", "S", and "G" requires clarification. Based on the current text it appears that all of E, S and G factors can manifest as risks through the liability transmission channel, but only E factors can manifest as risks through the physical and transition transmission channels. However, social factors can also manifest as risks through the transition transmission channel.

Lastly, as we have highlighted in relation to physical risks, to ensure the consistency across definitions throughout the discussion paper, we suggest avoiding the use of examples within the definition. The thought process established throughout the document together with the substantial literature on both physical and transitions risks would favour a "less is more" approach to the definitions.

5. Please provide you views on the proposed definition of social risks and governance risks. As an institution, to which extent is the on-going COVID-19 crisis having an impact on your approach to ESG factors and ESG risks?

Page 44, ¶179: "Social risks are the risks posed by the exposure of institutions to counterparties that may potentially be negatively affected by social factors"

Clarity on definitions

We suggest including in the definition a clarification as to what is meant by the mentioned social/governance factors. From point 72 we understand that EBA refers to social factors as related to 'the rights, well-being and interests of people and communities' and they include for example '(in)equality, health, inclusiveness, labor relations, and investing in human capital and communities.'" Could EBA expand on how these risk factors relate to what is part of the UNGP's and the Declaration on Human Rights? The definition as it is

now is quite high level and thus does not provide much guidance or detail. We understand from the paper that the primary focus of the EBA for now is on climate and environmental risks, but we would expect the EBA over time to come with a more comprehensive definition of social risks, as ESG risks are all introduced here as part of the mandate of EBA.

COVID-19

Regarding COVID-19 impact on approach to ESG, the relation between ESG risks for bank's counterparties and COVID-19 is not always obvious or straight-forward. For some banks, it is currently too early to identify any negative impact on client as a result of COVID-19. For some banks, COVID-19 has resulted in additional questions in specific client engagements in sectors that appear seriously impacted. In general, it can be stated that Covid-19 has certainly increased attention and awareness of ESG risks themes as influencing financial risk.

Page 45, ¶85: "Governance risks are the risks posed by the exposure of institutions to counterparties that may potentially be negatively affected by governance factors".

We believe Governance risk definition is acceptable, however we consider more clarity is needed on what governance factors mean beyond the examples provided in the text of code of conduct and AML. It is paramount to clearly understand both governance and social factors to avoid the double counting of governance and social risks that have already been taken into account in the assessment of other existing risks, such as operational risk or credit risk.

Additionally, we would like to highlight that provided examples seem to go further than the governance risk scope, for instance diesel gate should be linked to reputational risk instead of to governance risk.

Moreover, as previously raised in question 2 we are concerned of the extent to which institutions would have to be aware for social and governance risks when considering the full value chain in a company's production cycle. The scope of counterparties' risks that banks are able to acknowledge and manage should be limited; if not the inclusion of all potential ESG risks across the value chain of counterparties/companies may lead to diminished access to finance for some companies in their transitioning efforts as banks would try to limit their liability risk.

In addition, it is important at industry level we have a common understanding of the relationship between \materiality, the value chain with our providers and the direct and/or indirect risks...

6. Do you agree with the description of liability transmission channels/liability risks, including the consideration that liability risks may also arise from social and governance factors? If not, please explain why.

Page 47, ¶90: "Liability transmission channels/liability risks are the risks posed by the exposure of institutions to counterparties that may potentially be held accountable for the negatively impact through their activities on the environment, the society and their governance factors."

Liability risks (just like reputation risks) may arise from environmental, social and governance issues. ESG risks may influence liability, but likely only in combination with traditional financial risks or failure to act. In turn, reputation and liability risks may potentially lead to financial risks for clients and financial institutions, depending on the circumstances at hand.

Liability risk in our view is a risk type. ESG risks (climate risks, environmental risks, social risks) are drivers/ transmission channels - of potential reputation, liability, and financial risk. This also counts for the governance risks definition. As with social risks, we suggest clarifying what is meant by governance *factors*. As far as we understand, governance factors may be considered negatively both in the definition of governance risks and within the liability risks. We would advocate to avoid the double counting of risks.

Also, there might be ESG liability risk that materializes solely to the financial institution itself, which would fit the definition of the EBA: "*Liability risk relates to the risks stemming from people or businesses seeking compensation for losses they may have incurred due to ESG factors*". However, the paper only mentions counterparties in the example ("e.g., when institutions' counterparties are held accountable for the negative impact through their activities on the environment, the society and their governance factors"). As liability risk might also arise without the exposure to counterparties, but also through the operations of the institution itself. We would welcome clarification on this point.

7. Do the specificities of investment firms compared to credit institutions justify the elaboration of different definitions, or are the proposed definitions included in chapter 4 also applicable to them (in particular the perspective of counterparties)? Please elaborate on the potential specificities of investment firms in relation to ESG risks and on how these specificities, if any, could be reflected in this paper.

The proposed definitions included in chapter 4 should also be applicable to investment firms. The specificities of investment firms compared to credit institutions do not justify a separate definition of ESG risks. General definitions should be used, while the exact implementation of such definitions would naturally differ from institution to institution depending on its size, complexity and type of business activity.

Yet, there are some differences on why risks can be different for investment firms:

- The concept of counterparty may be less relevant as ESG risks may manifest through the assets they held as part as of their investment activities in general. Nevertheless, beyond the reference included on page 28 to the assets investment firms hold, this nuance is not included

throughout the rest of the document. For this reason we advocate to nuance the definitions provided within the reference both to counterparty and/or assets investment firms hold to accommodate its usability/applicability for credit institutions but also for investment firms. Difference lies in complexity at the counterparties.

- Investment firms are most often able to change their portfolio composition very swiftly.
- The due diligence process for an investment by an investment manager is often more limited in scope than a bank does for its lending. The limitations come from the ability to change the composition of the portfolio but also from a different fee structure which makes it harder to do the same due diligence.
- Investment firms can more easily add investment instruments for diversification or hedging purposes, which will influence the risk perspective.
- These differences between the two institutions lead to different perspectives on risk, financial and ESG risk. While defining ESG risks, one should take account of these different perspectives.
- All the examples provided in the document are related to loans (e.g. p.33, 36. "loans to agriculture/automotive."). Therefore, we would suggest including also examples related to investments.

Quantitative and qualitative indicators, metrics and methods to assess ESG risks (Chapter 5)

Do you agree with the sequential steps identified in this discussion paper for the incorporation of ESG risks in institutions' management practices? If not explain why.

Yes, we agree with the sequential steps identified in the discussion paper.

8. Please provide your views on the relevance and use of qualitative and quantitative indicators related to the identification of ESG risks.

We agree that ESG risks need to be identified through qualitative and quantitative indicators. The nature of the preferred indicator(s) will be driven by a combination of factors, for example the nature of the risk, the data available, models available for quantification, scenarios, etc.

The combination of both metrics is paramount. The qualitative and expert judgment indicators fill current information gaps that are necessary for the quantification and projection of variables. The combination of both may give sense and criterion to the quantitative results especially in the use of models (Scenario Analysis and Stress Test).

At the moment, given the different restraints or challenges described in chapter 5 (incl. uncertainty, lack of data, methodological constraints, time horizon mismatch etc) it is not yet possible to have many quantitative indicators indicating financial implications of ESG risks, certainly not over all sectors of our full portfolio over the short, medium and long term. On a client level in certain cases there is more quantitative information, depending on its reporting and transparency, on specific indicators. That does not mean there is a methodology quantitatively estimate what those datapoints mean in terms of future (financial) risks for that client. This remains a works in progress for banks as well as supervisors. The EBA should provide flexibility and encourage alternative methods, metrics, and indicators in the short term in order to bring all ideas forward.

9. As an institution, do you use or plan to use some of the ESG indicators (including taxonomies, standards, labels and benchmarks) described in section 5.1 or any other indicators, inter alia for the purpose of risks management? If yes, please explain which ones.

The non-exhaustive list of ESG indicators provided is an important starting point to obtain information on ESG related issues, and they can form the basis for the development of product offerings, and some banks have considered them as part of product taxonomy development (separate from a risk taxonomy of sectors).

In addition to those mentioned in section 5.1, the sustainability disclosure regulation also includes an extensive list of indicators, as well as the future label for the European Green Bond Standards for which banks are still awaiting the final EC proposal.

Some banks are already using indicators. A few examples and observations:

- For example, the EU taxonomy is being used for the categorization of sustainable finance product offering. That is not linked to risk management, although the expectation is that steering towards sustainable product offering will help de-risk portfolios.
- An example of qualitative sustainability criteria in bank's policies are the sustainability criteria in bank's policies. An example of quantitative indicators -to minimize inside out sustainability risk- is financed emissions for climate and indicators for biodiversity.
- Other standards like ISO are of course known to banks. That does not mean quantitative information is available on how our clients are doing compared to these standards or how many of them have aligned their business practice with these standards.
- Some banks are likely to use directional indicators which give more context to traditional financial risk indicators. Data availability will drive much of this. The current versions of TCFD and EU NFRD could be the starting point, again giving some flexibility depending on the context for an institution.
- Generally, we clearly acknowledge the many fast developments in this area. We welcome concrete guidance from EBA on this question, that is which taxonomies, standards, labels, and benchmarks does EBA consider useful for risk management, and what would integration into risk look like exactly.

However, most of the indicators are not suitable for risk management.

- The EU taxonomy is a case in point as it provides a list of activities, but there is no historical data that implies that lending to these activities has a more favorable risk (repayment capacity) profile, neither it provides a future risk outlook. A company that engages in sustainable activities may be better positioned from a sustainability / reputational risk angle, but there are many other factors that can unfavorably affect its financial performance (e.g. unbalanced debt/equity structure, poor product offering, etc.).
- Another example is information on emissions, and related information on breaches of existing regulation, are also important to understand a company's position with regards to decarbonisation of activities. However, emission levels can be easily changed, for example through the sale of activities to a third party or by the acquisition of new activities that can be perfectly legitimate and be transition risk / credit positive.
- Biodiversity markers can also be misleading, and often require full disclosure by companies, as they can descend to a geographical level that is not available to banks. Especially when referring to "own, or via value chain". In addition, these activities may be conducted under local law, with full permits, and no issues.
- Finally, the indicators are EU centric. They might not be applicable (thresholds, regulations, etc) in other jurisdictions where the Credit Institutions operate. It may well be more difficult to ascertain the applicability of these standards, labels and benchmarks outside the EU unless existing leading position in EU in this field will not influence or determine word wide standards. This is an important issue for NGFS and the International Platform for Sustainable Finance.

10. As an institution, do you use or plan to use a portfolio alignment method in your approach to measuring and managing ESG risks? Please explain why and provide details on the methodology used.

Our current understanding on portfolio alignment methods is that this relates more to strategy and business opportunities than to risk management, although we understand that this is a very dynamic topic, and the information could be used as a qualitative risk indicator of the companies' transition trends in the medium term.

Some banks are currently piloting a portfolio alignment method as an initial tool or and considering other methodologies with external data providers, which also provides alignment metrics.

Additionally, we maintain a close watch at the development of different initiatives relevant for banks in this space. We follow the developments of other initiatives, where although the supporting methodological concepts are the right way to start addressing this topic for banks, the criteria to recognise full application of the approach do not correspond with current data availability nor with the level of development of the methodologies for banks (at different stage of development than specific approaches defined for corporates in specific sectors).

It is important to highlight the heterogeneity in approaches and the difficulties in assessing alignment.

It could be interesting to know whether the regulatory community is planning to use any external or internal methodology for analysing the portfolio alignment as an input for prudential regulation, as they mentioned other methodologies without explicitly supporting them.

Regarding S&G and lack of developments of alignment methodologies a phase-in approach, starting with climate, would be necessary.

11. As an institution, do you use or plan to use a risk framework method (including climate stress testing and climate sensitivity analysis) in your approach to measuring and managing ESG risks? Please explain why and provide details on the methodology used.

Stress testing is particularly challenging, as it requires extensive resources, is connected to a problem of finding a full set of scenarios to cover both probable and rare yet possible outcomes. Climate sensitivity analysis, being a simpler form of integrating climate risks into financial modelling, could be a working solution even for smaller banks, yet there is not enough experience at the market within this method.

Saying that, there are already banks progressing down the path of sensitivity and scenario analysis related to transition risks. However physical risks developments are considered more appropriate by some banks as a risk management approach for measuring climate change related risks both on a portfolio basis and on an individual customer basis. Sensitivity and scenario analysis are seen as a first step before full integration into a stress testing model.

We fully agree with the EBA's assessment that methodologies are still in an early form and that they all require a substantial degree of subjective judgement. As mentioned in the previous question, banks are also considering other methodologies from external

providers, given that for now there is no capacity for most credit institutions to develop these models/methodologies in-house.

For this reason, we would welcome clear regulators views on to which extent the use of external provider methodologies will be acceptable over the time whether either as a long-term or short-term solution having in consideration that existing limitations to develop in-house methodologies are still going to continue in the coming years.

This is a cornerstone issue in order to be able to balance the investment effort in these external methodologies. We are especially concerned about it since experience has demonstrated that the use of external methodologies related to credit risk models has been penalized in a regulatory basis, being the internal developments the preferred options by regulators.

12. As an institution, do you use or plan to use an exposure method in your approach to measuring and managing ESG risks? Please explain why and provide details on the methodology used.

This approach is closely linked to the Risk method described above.

We support that an internal assessment of ESG factors has to be performed based on risk criteria; however as mentioned previously a there is a high dependency on external providers, potentially leading to an increase in market power. While ESG ratings provided by specialized rating agencies are a good way to secure industry-wide, coordinated understanding of ESG risks connected to various counterparties there is however a urgent need for a higher degree of method transparency and consistency by ratings providers as also substantiated in our response to the Renewed SF Strategy consultation of the EC, or approval of specific ratings are approved by regulators. The financial load of investing into external data without being certain they are audited, reliable and they meet regulatory approval is too high in particular for a small institution that will have to rely on internal developments for which many times capacities are lacking.

Some small, non-complex financial institution consider exposure method to be the best approach to assessing and managing ESG risks.

13. As an institution, do you use or plan to use any different approaches in relation to ESG risk management than the ones included in chapter 5? If yes, please provide details.

Banks constantly review the methodological developments in the market to improve/complete current/mentioned approaches. But the investment required for any of the approaches does imply a certain amount of "no regrets" decisions in the immediate future if banks are to meet expectations (regulators, supervisors, stakeholders). This could make sudden changes to the approach costly and potentially difficult to implement.

We welcome the EBA´s flexibility on the method to be used by institutions. However, this flexibility should be understood as a long-term approach, as choosing a specific methodology has significant investment implications for the development of systems. We therefore encourage the EBA to maintain this flexibility over time, or at least, to provide a

clear timeline with sufficient early warning for institutions to be able to update the systems and processes accordingly.

14. Specifically for investment firms, do you apply other methodological approaches, or are the approaches described in this chapter applicable also for investment firms?

In general, we consider the metrics and methodologies described in this chapter aligned with those approaches for investment firms.

We would like to add a clarification on the table on page 76. In it, the “alignment” method is considered as something linked to the portfolio and not applied at the individual level, but in the case of asset management, the analysis is also done at the asset level (by company, not only at portfolio level).

In addition, we consider the analyses performed under both the alignment and the exposure methods should be complemented with an active ownership. Engagement is key in order to better understand companies’ strategic plans, how they are managing ESG risks and opportunities, and how prepared they are to face ESG challenges. In this sense, collaborative engagement initiatives like Climate Action 100+ are relevant for asset managers.

Finally, in some cases the discussion paper refers to dialogue with “clients” (for instance in box 10, page 60) which in case of investment firms is not a valid reference as they are not clients, but companies in which investment firms invest in. Therefore, we advocate to nuance this reference both to clients and/or companies in which investment firms invest in.

The management of ESG risks by institutions (Chapter 6)

15. Please provide your views on the extent to which smaller institutions can be vulnerable to ESG risks and on the criteria that should be used to design and implement a proportionate ESG risks management approach.

The extent to which institutions may be precisely vulnerable to ESG risks varies. It is a function of the institution’s business model, relative size, internal organisation and nature and complexity of its activities. In addition, one might look at the markets they operate in (how regulated they are) as well as their investment strategy (private banking focused, mortgage lending, or an investment fund focused on fossil fuels) as indicators of their vulnerability to ESG risks. Specific vulnerability relates to the complexity and cost of data and data handling.

The principle of proportionality is important. We therefore welcome the inclusion of proportionality principle through some points of the discussion paper, however we are concerned about the linkage done between proportionality principle and the size of institutions in specific paragraphs across the discussion paper (paragraph 109).

We think that automatically signalling size as the driver for assessing proportionality should be avoided. Assuming that large or smaller banks are more or less vulnerable to ESG risks simply because of size is not accurate. It is important that other criteria are taken into account such as business model, geographical location, etc. as included in this Discussion Paper.

There is therefore a need to get more substance to the definition and translation of the principle of proportionality. It is yet unclear (how to assess) to what extent proportionality can be applied by banks in terms of depth and speed of incorporating and managing ESG risks. The principle of proportionality does not only relate to size and the complexity of banks. It relates to a great extent to the materiality of ESG risks resulting from the business model.

A proportional approach should be taken which ensures that LSIs further develop, but that the management system and oversight are not disproportionate to the level and materiality of the financial risk. It is suggested to make the criteria for LSIs more straightforward, for instance by making ESG risk /climate risk part of an institutions Risk Appetite Framework, a Sustainability Risk Management Framework (or integrated in the full risk Management framework), TCFD reporting, due diligence, and monitoring, but in proportion to the ESG-related financial risk. Assurance is a point of attention as this is already costly for LSIs on the normal financial elements. We emphasise proportionality and materiality emphasized here, since cost and resource constraints are a very real issue.

16. Through which measures could the adoption of strategic ESG risk-related objectives and/or limits be further supported?

With 'strategic' ESG risk objectives we understand goals aimed at reducing financial risk as opposed to also goals aimed at reducing actual climate risks (i.e., aligning with the Paris goals as, while banks are acting on both, the latter would fall outside the scope of (i) prudential supervision, and EBA's mandate which is to contribute to a single set of harmonized prudential rules for financial institutions throughout the EU.

Banks are gradually progressing in terms of governance at board level providing a holistic view of the relevance of ESG risks as well as setting internal and external KPIs and external commitments relating to sustainable financing.

Having said that, to be able to set clear limits/objectives, banks need to be able to pin down strategic ambitions, which greatly depends on proper methodologies being developed and, in addition, a clearer regulatory "picture" in terms of timelines and interaction among different regulations, as well as clearly defined few minimum standards, recommended practices and methods that could provide level playing field for all institutions. This would provide a more straightforward view on the strategies and investments that would be supportive of EU objectives.

The variety in determining parameters of materiality or assessing counterparty risk makes it very hard to compare results (also between institutions) and as a consequence, the content of reports.

Not only the publication of ESG specific papers and guidelines is useful. Extending the currently existing guidance and level 2 regulation on specific risk type to include more practical approaches and solutions to ESG risks would be beneficial. In addition, clear alignment between all publications within and across the European institution/agencies and should be ensured.

Lastly, governments and regulators need to prevent arbitrage by institutions and/or counterparties and strive for a level playing field. For instance, there is a difference with developing countries, both in objectives, policies, and priorities as well as in most urgent risks.

In general, there is one major issue that will need support: the availability of reliable, audited adequate, recent, and low-cost data. Besides, also methodologies should be developed to translate these data to tangible risk-data. Currently financial institutions are limited because of a lack of data coming from counterparties.

17. Please provide your views on the proposed ways how to integrate ESG risks into the business strategies and processes of institutions.

This section advocates that institutions adjust their business strategy by incorporating ESG risks as drivers of prudential risks, which EBA sees as a progressive risk management tool to mitigate the potential impact of ESG risks. This should be done namely through extending the time horizon for strategic planning, including ESG risk scenarios, setting and disclosing ESG KPIs, offering sustainable products, and adjusting business processes to reflect ESG risk-related strategic objectives and/or limits in the engagement with borrowers, investee companies and other stakeholders in order to lower the ESG risks associated with those exposures. Much of this section is explaining or evidencing trends in the marketplace, such as how the Principles for Responsible Banking, Equator Principles, Sustainable Development Goals and EU Taxonomy have shaped ESG risk management and led to sustainability linked products. In this respect, we agree.

Various institutions have focused their business model on sustainability to varying degrees, starting with philanthropic focus and moving towards integrated business strategy along the way. Promoting sustainability through green bonds, social bonds, sustainability-linked financings and sustainable improvement loans are good examples of how niche-financings spurred industry-wide competition (via league tables etc). It is necessary and a good industry practice to have prudential management of ESG risk of general products as well as Green / Sustainable products.

Concerns

The main challenges regarding ESG risk management are equally valid to the integration of ESG risks into the business strategies and processes of institutions. For instance, the time horizon of ESG risks is longer than the regular time horizon for strategic planning, the prudential timeframe⁷ and the supervisory time horizon and there are also other methodological challenges to integrate these risk divers in the risk management framework. There are many uncertainties about the actual effects, which is partly due to the absence of historical data. Especially environmental (transition) risk is more of a long-term risk. It will be challenging to ensure that long-term effects of environmental risks are sufficiently highlighted in business strategies.

In order to reflect the ESG risks in the supervisory evaluation, the EBA sees a need to proportionately incorporate the ESG factors and considerations into the business model analysis, in particular with regards to the analysis of business environment, the current business model, the analysis of the strategy, and the assessment of the viability and sustainability of the business model.” Although this is preferred over the January 2021 deadline of the ECB, it also creates some uncertainties. It is unknown when certain requirements will apply and this may also result in an unlevel playing field. We would welcome more clarity on this point.

Engagement with customers and other relevant stakeholders

While we recognize that the dialogue with clients based on an internal ESG assessment can be an important tool to transition and transform economies in more sustainable systems (§180 & 181), EBA should clarify that it should be realized on a best effort basis by the lenders of the counterparty, and firstly with customers with the main ESG stakes or challenges Banks can accompany and complement the EU policy, but they cannot substitute policy actions.

We envisage several shortcomings to for banks in build up a systematic dialogue. Nevertheless, banks are committed to it but would appreciate a best effort basis initial period or a clear phase-in path.

EBA also suggests in §223 to enter into a constructive dialogue with critical counterparties, which narrows the range of counterparties with which to set a dialogue. Regarding the “critical counterparties” we think that they could be those individuate by the bank’s preliminary assessment and also in the light of indicators (like carbon footprint for climate related transition risk) already present in some other pieces of legislation (like the “non-binding guideline for NFRD reporting” issued on June 2019).

The dialogue with the industry associations described in §183 should be left at the bank’s discretion. As it is time consuming, it makes sense for each bank to focus only on a very limited number of sectors where the bank is driving the market (e.g.: dialogue with the mining and oil & gas professional associations at the time of the discussion and adoption of the Equator principles). In addition, the dialogue should be based on assessments carried out with methodologies and standards shared at industry level, so that the customer assessments carried out by the various credit institutions could be transparent and comparable with each other.

On the other side, it is also sometimes practically impossible for trade associations to engage with individual companies and therefore best practice is to engage between business associations.

IT systems

According to the paper, (page 114) institutions should be able to generate aggregated data efficiently on a timely basis to meet a broad range of on-demand requests. EBA should specify that this is expected from banks in the medium term. As long as the taxonomy remains incomplete, the revised NFRD not implemented, stress tests exercises are still in exploratory mode, banks cannot develop complete databases that will enable “to meet a broad range of on-demand requests”. Banks need to include the conclusions and main findings of all these exercises to see which data are most useful to be systematically included in the databases and then start building historical series. The resources should be devoted to sound risk management rather than template fillings.

18. Please provide your views on the proposed ways how to integrate ESG risks into the internal governance of institutions.

ESG risk is a relatively new subject and a lot of new legislation is coming. Before integration of ESG risks into internal governance, the impact of ESG on the institution must be adequately analysed. The availability of expertise to do so is however a challenge.

It should also be pointed out that regulations play an important role into the integration of ESG risks into the internal governance of institutions. For instance, the mentioned challenge of data availability is partly due to existing regulations that are preventing access to information.

We would urge EBA to help address this with peer authorities within the EU to ensure free/unfettered access of banks to the data that is needed to carry out the task. A central EU database and access to Member State databases would largely facilitate the data availability and automatization of the processes.

The “Conclusions and policy recommendations” set out in page 100 of the Discussion Paper includes a recommendation to “allocate the responsibility related to ESG risks to a member of the management body”. We have two observations in this regard:

1) Allocation of responsibilities individually to members of the management body

In one-tier systems, company law conceives the management body (board of directors) as one unique and inseparable body through which both management and supervisory functions are performed. All the members of the Board imperatively perform all the functions assigned to it as they are all, collectively, part of the decision-making process, and they all have the same rights and responsibilities; they are all under the same liability regime, for they act as one single collegial body.

The allocation of different roles and responsibilities to different board members is thus inadequate for one-tier systems, given that no efficient or real separation of responsibilities can be implemented where company law conceives the board as one unique and inseparable body through which all functions are performed, without prejudice to the role of the Managing Director.

Roles within the Board are primarily attributed for the enhancement of checks and balances, as well as to enable an optimum supervision and control and adequate running of the institution, but decisions within a collegial body carry no tags as to the types of members who adopted it.

2) Allocation of responsibilities specifically to the management body when they already rest with the senior management

Also, in line with what has been put forward in the preceding paragraphs, the fact that the Guidelines expects institutions to allocate responsibilities on ESG risks to a member of the management body would be hard to implement in institutions where such responsibility lies with a member of the senior management.

As a consequence of all the above, the suggested recommendation to “allocate the responsibility related to ESG risks to a member of the management body” shall be deleted.

Committees

Additionally, the DP includes a recommendation to consider ESG risk in the advisory role of risk committees or creating specialised committees such as sustainability committees proportionate to the size, complexity, and business model of the institutions. The clarity provided on the 26th of November public hearing explaining there is not one solution to incorporate ESG into the committees while either a special committee or an existing one ensures the appropriate attention and appropriate integration of the ESG risks into the overall risk management framework is welcome and should be reflected in the DP. It is important that institutions can keep flexibility in this sense.

Finally, as already mentioned, we advocate to avoid size as the driver for considering the proportionality principle, allowing banks to determine if creating a specific committee or using the existing ones fit better to their internal governance structure.

Risk management function/compliance function

Point 211: “The risk management function and the compliance function play a key role in the approval of new products”.

To avoid possible impression that the Compliance Functions has a secondary role in the approval process of new products we would recommend amending the sentence, placing Compliance Function before Risk management function.

Point 212: “At this point, it is important that members of staff in the internal audit function have the adequate skills and tools to understand and challenge specific decisions”. In the previous points no. 210 and 211 no equivalent provision has been made. Risk management and compliance functions should also have adequate skills in order to face these new challenges.

Thus, we ask to amend 212 by deleting the sentence or amend previous points 210 and 211 specifying that even Risk management and Compliance Function needs adequate skills to understand and challenge specific decisions.

Remuneration

With reference to the proposals on remuneration, we agree that institutions that have set ESG related objectives or that have set limits to ESG risks should reflect it in their incentive schemes (e.g., linking variable remuneration to the successful achievement of ESG related objectives); however, this should be done **in a proportionate and progressive way. In a first phase, the scope of this recommendation could be restricted to senior management individuals who are responsible for the definition and the implementation of the bank's strategy on such matters.**

While we consider it is important for all staff members to have general knowledge on ESG risks we do not see the need for specialisation in this area other than through the establishment of ESG experts that can support the firm in certain aspects (e.g., risk management models, impact assessments, product development).

Considering the characteristics of ESG objectives, this can be easily done in long-term incentive schemes, whereas it could prove to be more challenging (yet not impossible) in short-term incentive schemes.

ESG objectives tend to be difficult **to measure under a quantitative perspective. In order to assess their level of achievement, it could be useful to allow qualitative discretionary evaluations, based on objective evaluation drivers.**

ESG objectives should be closely connected to the area of responsibility of the staff member, rather than being general institution-wide objectives set for all the staff of the institution. For example, in the banking sector, HR managers could be assigned ESG objectives related to human resources management; managers of commercial structures could be assigned ESG objectives related to the development and sale of green bonds and S-loans. Further examples of ESG objectives that could be used in incentive schemes are so-called "impact" related objectives such as the contribution of the institution to the education of youngsters, assistance to businesses to support their growth, and the presence of the institution in relevant global indexes

19. Please provide your views on the proposed ways how to integrate ESG risks into the risk management framework of institutions.

ESG risks have already been integrated into the risk management of various credit institutions in certain areas. For instance, there are 45 (mainly) credit institutions from Europe (and 110 worldwide) who are signatories of the Equator Principles, which is a *"risk management framework, adopted by financial institutions, for determining, assessing and managing environmental and social risk in projects and is primarily intended to provide a minimum standard for due diligence and monitoring to support responsible risk decision-making."* The Equator Principles

Financial Institutions (EPFI) have a large number of guidance documents, best practices, roundtables and members-only forums available to members to discuss the management of ESG risks.

What has not been widely established yet is the assessment and forward-looking quantification of those ESG risks, in other words: the potential financial implications. The EBA Discussion paper now asks for banks to 1) formalize their ESG [financial] risk appetite, 2) set out appropriate policies and procedures, 3) collect data related to ESG risks [and financial impacts], 4) develop risk monitoring metrics and management practices, and 5) stress test them.

The framework proposed in the DP is aligned with the internal roadmaps that the industry is following to integrate ESG risks into risk management framework, and with the ECB supervisory expectations as well as the EBA guidelines on loan origination and monitoring.

Over time these expectations should be achievable, but there are still challenges. The first one is the availability of reliable, audited, adequate, recent, and low-cost data. Also, the methods on how to integrate ESG risks into the risk management framework are still under construction. To incorporate the long-term time horizon in which ESG risks could materialize into a risk management framework which is typically less long term, to deal with other, more short- and medium-term risk types such as credit and market risk, provides an additional challenge. This is already the case for climate change risks and will be even more of a challenge for social and governance risks and their financial impacts.

A phase in approach may therefore be necessary. It may be advisable to commence with a formal requirement to include ESG risk as a theme in Risk Appetite Frameworks. This is probably the main requirement needed, since that change by itself would have a cascade effect through risk management governance, processes, and reporting. It is important that this is managed as another mainstream financial risk theme, one which can influence credit risk, liquidity risk, market risk, operational risk. If formally recognized as a risk theme, it will be among the many aspects which are integrated into governance and management. Similarly, a separate statement regarding remuneration might be redundant/duplicative, since ESG would *already* be part of the integrated financial performance and risk considerations.

Flexibility on methodologies

The DP allows flexibility to institutions regarding the methodology and metrics to use to assess ESG risks (see paragraph 234 of the Discussion Paper). While we support this open approach, we think it is important that the EBA clarifies whether they will be maintaining this flexibility over time or whether banks should expect a more specific guidance regarding what methodologies to use once there is more clarity on the outcomes, time frames (for instance if the direction is to go beyond 10years horizons, methodologies with shorter horizons will be automatically excluded).

Integration of ESG factors in modelling and capital planning

We welcome EBA comments on the difficulty to include ESG factors in internal credit models. The events depend on scenarios that are long-term, so they cannot be integrated in the credit models but projected. Historical data cannot predict the future, for which reason they can only be calculated by means of scenario analysis in the future and need new forward-looking approaches and new methodologies given the unprecedented nature of ESG and specifically CC factors and risks.

Banks will have to progressively test relevant ESG factors to complete the gaps in data, methodology, assumptions that have not been established and tested with soundness.

Stress testing

While we welcome the fact that EBA recognizes that stress tests are still too exploratory exercises to trigger capital requirement consequences. Stress tests can give very different results depending on the methodology used, the assumptions included the time horizon and the scenarios which will be tested (smooth convergence, rapid convergence, no convergence).

The EBA foresees a gradual development of methodologies and approaches to a climate risk stress test, while considering the methodological and data constraints. The objective of a climate risk stress test should be to inform on the resilience of institutions' own business model and investment strategies.

We consider climate related scenario analyses as the most appropriate tool to assess the materiality of ESG risk drivers and their impacts on the business model and welcome the pilot exercises launched by EBA and supervisors on assessment of climate risks. Thanks to fruitful experience and lessons learnt, such exercises pave the way, on both supervisors and institutions' sides, for the development of reliable and robust regulatory and internal methodologies for climate-related scenario analyses. Forward-looking analyses are naturally the best approach for capturing potential impacts of ESG risk drivers, because ESG risk drivers are intrinsically forward-looking in the very long-term. Moreover, climate-related sensitivity analyses outcomes should for the time being focus on ESG-related KPIs, and in a secondary manner, specific financial indicators, in order to focus on the assessment of ESG risk drivers on the business model.

Consequently, such climate-related scenario analyses should remain clearly differentiated from solvency-related stress testing exercises, which use different methodologies, pursue different objectives, and therefore measure different impacts, based on different indicators.

We also welcome recommendation that institutions should leverage on the NGFS scenarios to overcome the modelling challenges on climate risk scenarios. However, it is important to bear in mind that some institutions need to cover a diversified portfolio with a lot of sectors/subsectors in different geographies and that granularity is incomplete at the moment, and it will take some time for the NGFS to be able to finalize the task.

Similarly, the use of "multiple scenarios" to assess climate risks should be clarified to avoid adding further uncertainty and heterogeneity in outcomes across institutions, as for now there are not enough accuracy to cover all the sectors and geographies in the different climate scenarios for orderly and disorderly transition pathways and year horizons etc. among other variables.

Finally, we have some concerns around the level of ambition/expectation that the EBA set on the institutions' data infrastructure. At the moment, while data availability is an area of continuous progress, serious challenges remain, and more are coming to light. We therefore believe that the EBA's expectations on how feasible it is for institutions to have all the relevant data available to perform climate stress tests and respond to "a broad range of on-demand requests" could be too far reaching for now.

We would encourage the EBA to properly reference the challenges around data, institutions dependencies' on third parties including customers, data providers, etc., and acknowledge that as these are not standard tests, the same level of data consistency would be difficult to achieve for now. In addition, it is important to reiterate that we expect that the data quality and availability will gradually improve in the European Union as the reviewed NFRD and other initiatives are implemented, but this will not be the case in many of the jurisdictions where different institutions operate. As an example, energy efficiency certificate requirements do not exist in many of the geographies where our members operate, nor are corporate customers required to publish emissions data under local laws.

Pricing

We take particular note of paragraph 253, which calls on institutions adjust their pricing "*which should reflect also the risks driven from the ESG factors. Institutions should account for ESG risks in their pricing strategies.*" This is an important step which needs very careful consideration given that pricing is already dependent on global market forces. Any discussion on pricing should take place only after methodologies to identify, evaluate and manage the ESG risks are well advanced and implemented into ESG risk management frameworks.

20. The EBA acknowledges that institutions' approaches to environmental, and particularly climate-related, risks might be more advanced compared to social and governance risks, and gives particular prominence in this report to the former type of risks. To what extent do you support this approach? Please also provide your views on any specificities associated with the management of social and governance risks.

It is a matter of fact that Regulators and Governments, particularly in the EU, have thus far shown interest in climate-related and as of late Environmental-related risks. This is evidenced through the many climate related questionnaires that have been sent to institutions over the past 3-4 years, the attention given to TCFD, and even the recently published EU Taxonomy on Sustainable Finance.

There has been less focus on and guidance with regard to the extent to which institutions/banks are expected to acknowledge the "S" and "G" risks in their risk management framework. Additional attention for the "Social" and "Governance" risks could be encouraged through this policy, which might be beneficial to extending the focus beyond "Environmental" risks only.

Identifying SG risks of a counterparty is only possible after a thorough due diligence, providing necessary information is available, which is not suitable/possible for all counterparties and all issuers in a portfolio. However, we acknowledge that there are

consequences for institutions of not managing these risks, as can be seen through the activities of Business at OECD (BIAC) and increased use of the National Contact Point for the resolution of issues that arise from the alleged non-observance of the OECD Guidelines for MNEs in specific instances. The potential negative financial impacts of social (human rights) and governance risks can be large.

Hence, we would expect EBA to formulate a clearer point of view on this, also keeping in mind the many and fast regulatory developments with regards to human rights, children's rights and required due diligence at EU level. It could be helpful if the EBA could provide more clarity on the next steps or timeline by when it expects progress on governance and social risks. Identifying SG risks of a counterparty is only possible after a thorough due diligence, which is not suitable for all counterparties and all issuers in a portfolio.

In relation to specificities associated with the management of governance risks, it is worth recognizing that management/governance factors are an integral component of credit risk/operational risk assessments and ratings already such that any guidance from EBA is tailored at 'enhancing' without 'double counting' those factors.

21. Specifically for investment firms, what are the most relevant characteristics or particularities of business strategies, internal governance and risk management that should be taken into account for the management of the ESG risks? Please provide specific suggestions how could these be reflected.

As a general comment we note that these aspects of ESG Risk are not only relevant for investment firms. Credit institutions offering investment services would be affected in an equal way.

ESG risks depend on sector, geography, and type of investment (equity or fixed income). All these criteria should be considered when assessing the assets under management, and different methodologies or approaches could be followed to address these differences.

As mentioned in section 164, there are different strategies applicable in asset management. With regard to exclusions, we would like to clarify that they are not always related to a minimum non-financial score, but they are also related to specific (high risk) activities (e.g. fossil fuels).

Regarding the "Best in class approach", there is no need to be related to a specific ESG topic (although of course, this could happen for some products). In fact, it is quite general to apply this best-in-class approach related to a general ESG score. This ESG score is generally calculated taking into account the most material ESG topics from a sectorial perspective, provided that not all sectors face the same ESG risks and opportunities.

The main characteristics of Impact strategies are the intentionality to create a positive impact (as it is mentioned in the document), and the fact that this impact should be measurable.

In addition to the strategies mentioned, there are also others that should be considered.

- ESG integration: Systematic consideration of ESG aspects in the financial assessment.
- Thematic strategies: investing in specific activities or ESG topics (e.g. climate transition, water, circular economy, etc.)
- Active ownership: Voting and engagement could also be useful strategies to manage ESG risks.

With regard to the limited impact (or not existence) of ESG risks in investment firms not dealing on own account (e.g. manage portfolios on behalf of clients), we consider that, even though the impact could be different, these investment firms should also recognise and consider these impacts.

ESG factors and ESG risks in supervision (Chapter 7)

22. Please provide your views on the incorporation of ESG factors and ESG risks considerations in the business model analysis of credit institutions.

We agree with notion in the paper to proportionately incorporate the ESG factors and considerations into the business model analysis of credit institutions. The suggested steps for incorporating ESG factors and ESG risks considerations in the business model analysis of credit institutions are well structured and cover all major aspects. Developing regulatory calendar should be followed to avoid inconsistent introduction of requirements that are based on a still developing internal methodology and both internal and external data environment.

Banks consider the ESG factors primarily for their business development strategy and as such they do not represent solely potential negative impacts on bank's solvency. ESG factors should be considered primarily as the key vector for business development in the coming years. Consequently, the first step would be to connect ESG to the Business Model Analysis part of the ICAAP. A strong business model analysis enables informed strategic decision-making, supports the transition to a more green and sustainable business model, and therefore strongly mitigates risks potentially impacted by ESG risk drivers, such as business and strategic risks.

The main challenge regarding the incorporation of both ESG risks and ESG risks considerations in the business model analysis of credit institutions particularly lie in the Social and Governance sphere. More clarification is needed for the introduction of requirements for E, S and G as the Environmental part is more advanced while S and G are still at an early stage. Additional attention for the "S" and "G" risks could be encouraged through this policy, which might be beneficial to extending the focus beyond "E" risks only.

We would also like to point out that the current lack of data availability and the backward approach suggested in order to quantify whether the **impairment of asset** values is caused (and to what extent) by ESG risks, challenges the quantitative analysis proposed by the Consultation Paper. To understand the resilience of the entity's business model from a ESG risk perspective, since it would be partially based on the quantitative approach, the strengthening of entities' databases would be critical being this a lengthy process since it would also rely on the pace of the counterparties integrating the ESG factors into their management decisions and eventually in their disclosure.

23. Do you agree with the need to extend the time horizon of the supervisory assessment of the business model and introduce as a new area of analysis the assessment of the long term resilience of credit institutions in accordance with relevant public policies? Please explain why.

From a conceptual point of view, we understand why the time horizon of the supervisory assessment needs to be extended. The nature of ESG issues,

particularly climate-related ones, requires a longer time horizon of business model planning. The regulatory need to assess long-term resilience of credit institutions is also understandable. Benefit lies in looking at a variety of time horizons to manage the impact of climate change as different risks could materialize and inform strategic choices as well as risk appetite setting. Whereas classic stress testing models focus on quantifying the near-term impact that corresponds with the financial planning horizon, we recognize that for climate the impact is predominantly noticeable in the long term (reaching up to 2050).

From a practical point of view, there are several obstacles:

- review carry out on an annual basis. In order to assess any upcoming ESG risk (beyond 12 months period), we would understand the Competent Authorities have in place additional tools to gather those potential risks, for instance, the stress test where a more forward-looking approach is imbedded in the different scenarios considered.
- The reason why the current forward-looking assessment is in practice constrained to about 5 years is that the longer the time horizon, the greater the uncertainty. Extending the time horizon to 10 years or more would introduce a significant amount of uncertainty into this assessment. It is difficult to gauge if such an assessment would then lead to credible outcome.
- The key document to assess supervised entities' business models, both the viability ("ability to generate acceptable returns from a supervisory perspective over the next 12 months") as well as sustainability ("ability of an institution to generate acceptable returns from a supervisory perspective over a period of three years") is the strategic/business plan which seldom covers time horizons over 3 years. Therefore, while we see merit in adopting a more forward-looking approach, we would like the EBA to consider the challenge banks might face in striking the right balance between "extending the time horizon" and "making more robust and reliable strategic projections".
- It's important to consider the value of geographic and sectoral diversification in the assessment long term resilience of credit institutions. Some studies suggest that bank lending has remained reasonably resilient in the face of past natural disasters, at least where banks' exposures are relatively diversified across geographic regions. The cross-border transmission of climate-related risks via financial institutions could give rise to diversification, by transferring risks to those best placed to bear them globally. Cross-border bank lending might therefore play a role in diversifying, rather than amplifying, climate-related risks across a range of lending countries.
- The key hurdle on assessing either of these time horizons is around the access to adequate data and convergence of methodologies that can support the quantification of the impact. The need for long-term assessments is clear given the fact that loans with a long maturity, such as residential mortgages, that are given today should already be able to

withstand a substantial part of the energy transition and/or potentially strong physical effects from climate change. However, the outcomes should obviously be treated cautiously and in a very different way from the more traditional short to medium term assessments. This is clearly an example where banks, regulators and supervisors should team up to collectively determine approaches for this.

Specialized lending and project financing

In §339, EBA suggests banks should assess differently a project financing with high ESG performance led by a client with low ESG performance and the same project led by a client with high ESG performance. This comes in contradiction to the taxonomy philosophy, where financing of improvement measures (capex and, if relevant, opex) can be counted as Taxonomy-aligned if they are part of an implementation plan to meet the activity threshold over a defined time period.

EBA should also clarify whether this paragraph only covers specialized lending in the form of project financing or all specialized lending, including asset financing.

24. Please provide your views on the incorporation of ESG risks considerations into the assessment of the credit institution's internal governance and wide controls.

The ESG factors are already considered by some entities following their own approach, and existing guidelines and standards. In our view, the incorporation of ESG risks considerations into the assessment of the credit institution's internal governance and wide controls must be carried out following a homogenous approach embedded in existing Standards and guidelines and implemented within the internal governance arrangements in a proportionate way and progressively over time, taking into account their impact from a prudential point of view.

As the discussion paper states, the supervisory review should proportionately incorporate ESG risk-specific considerations into the assessment of the credit institution's internal governance and wide controls. A proportionate approach to the implementation, requires a more robust or mature process for the identification and assessment of ESG risks. Similar to the need for generic approaches to long-term scenarios and stress testing, the notion of a proportionate incorporation of ESG risks into the assessment of the credit institution's internal governance and wide controls requires a solid basis of measurement of these risks in order to establish objective supervision. This is also depending, at least for some counterparties, on finalization of the non-financial reporting directive (NFRD).

The EBA has to lead the process, establishing the definition of the ESG Risk, as well as a practicable calendar, since not all of the expectations and considerations in the activities and key processes (such, as an example ICAAP, ILAAP or stress testing) can be achieved at the same time. The role expected of the Risk Management Function, for Compliance Function and of the Internal Audit Function require a full definition of the ESG Risk, prior to adapting the internal regulation and/or defining skills or assigning roles and responsibilities in a 3 LoD Model approach.

Likewise, the embedding of the ESG risk in the key processes will require a clear definition, with common standards and indicators for their management and control.

25. Please provide your views on the incorporation of ESG risks considerations in the assessment of risks to capital, liquidity and funding.

Regarding the integration of ESG climate-related and environmental risk drivers into the prudential supervisory framework and the SREP, we would like first to remind (as also clearly stated by ECB in its ICAAP Guide) that ICAAP is an internal process fully owned and managed under banks' responsibility. Therefore, methods for integrating ESG climate-related and environmental risk drivers should be defined and implemented by banks in the way they deem adequate for internal economic risks monitoring and decision-making purposes.

Indeed, ICAAP is a complex process that connects several strategic decision-making and risk management processes, articulated with a comprehensive internal economic perspective, a normative regulatory perspective, and a forward-looking dimension, all together enabling the bank to demonstrate its present and future capital adequacy.

We agree with NGFS and EBA findings that integrating ESG climate-related and environmental risk drivers into the prudential supervision framework remains very challenging, for several reasons:

- ESG covers a wide range of concepts, some of them being still under development as of today.
- Understanding and awareness of ESG still requires a huge mobilisation to achieve the defined goals.
- From a practical point of view, after all progress and achievements realised in the recent years, there is still a lot of work to be done only to build a common understanding and definition of ESG.

Consequently, considering the above-mentioned complexity and stakes of the ICAAP and the SREP, the optimal prerequisites for a consistent integration of ESG into the current prudential supervisory framework are not met yet.

With respect to the discussion paper, it approaches ESG risks to liquidity along three axis: (i) Short-term, (ii) Long-Term and (iii) Governance/risk management framework. Below we comment on each of them:

i) Short and medium term liquidity risks:

ESG risks, when considered on a "stand alone" basis, are extremely unlikely to cause buffer depletions that are even close to those resulting from severe liquidity stress tests of idiosyncratic/market-wide nature run by the entities. ESG risks have mainly indirect impacts on liquidity, whereas existing liquidity stress are focused on stressing "direct" liquidity risk drivers. In this sense, "stand alone"

evaluation or ESG risks to short-term liquidity do not add significant value or modify buffer calibrations, despite the high burden it may cause to entities.

In case of an ESG risk occur in conjunction with idiosyncratic/market wide liquidity stress, the different subsidiaries of the Group are currently running combined scenarios in its liquidity stress test in which are considered market-wide risks (that may come from a ESG risk) and idiosyncratic liquidity stress event. Nevertheless, the plausibility of such “specific double stress” scenario should be assessed by individual entities in the light of their specific business models, the markets in which they operate and the capital impacts of that specific ESG risks may cause to them. Conversely, ESG risks uncorrelated to idiosyncratic/market-wide liquidity risk drivers should be disregarded for liquidity adequacy purposes, given that they imply a remote/implausible “tail-tail” risk.

ii) Long term liquidity risks (funding):

Approach in the discussion paper to potential impacts on funding seems reasonable. ESG risks to funding should be assessed in financial/funding plans, in terms of funding stability and market access, especially in relation to the ESG strategy and positioning of the entity. This assessment should probably be more qualitative than quantitative.

iii) Governance and risk management framework:

We consider positive to incorporate ESG risks in the different aspects mentioned in the document, to the extent explained above: liquidity strategy and risk tolerance, risk identification, stress testing, contingency plans and funding plans.

Capital

With respect to capital, the described indirect effect from ESG seems plausible in the sense that it materialises through other risk types. The paper mentions market, credit, and operational risk, this seems an inexhaustive list of relevant risks.

It makes sense to assess credit risk driven by ESG risks on both short and long horizon and the provided list of controls are useful for this. For credit risk we find it useful to state explicitly that an ESG risk event transmits to a credit risk impact via either increased risk of default of the counterparty, devaluated collateral value, or both. Although important, it can also be noted that transition risks are inherently hard to assess quantitatively, especially in the long term and in case of a disorderly transition, due to possibly unpredictable government measures, market effects and linkage within the economy.

Avoiding financing of sectors or counterparties with a “high” ESG risk and that do not show at all a possible auditable improvement path however could be a mitigant of many transition risks, but this is obviously a costly decision that might be implemented only waiting for better risk driven solutions.

Supervisors should remain very prudent when deriving increases in P2R and P2G as a result of these risks, as stated in paragraph 124 of the Guide, which recognizes that deriving quantifications of capital requirements in climatic stress tests is complex.

Liquidity and funding

For liquidity and funding, it seems plausible that liquidity and value of assets could be impacted, as well as retail cash flows. These are incorporated in liquidity stress testing, although not explicitly attributed to ESG risks. However, liquidity and funding seem less pressing as the ESG risks are also largely considered to have a longer-term impact while liquidity risk is mainly a short term risk.

While we support the use of scenarios and stress testing to assess the potential impact of ESG risks on capital and liquidity buffers, this underpins the need for base-line scenarios with the associated definitions of ESG risks. This is in line with EBA's conclusion (page 139), where we consider that a staged approach of translation into Pillar 2 requirements should be taken.

The remaining points with respect to liquidity and funding seem rather unspecified. The paper regularly mentions "changing assumptions", e.g., with respect to funding planning, but elaboration on how and why certain assumptions would change is lacking.

26. If not covered in your previous answers, please provide your views on whether the principle of proportionality is appropriately reflected in the discussion paper, and your suggestions in this respect keeping in mind the need to ensure consistency with a risk-based approach.

We strongly endorse the application of the principle of proportionality, but invite EBA to elaborate on the following aspects:

- There is a need to get more substance to the definition and translation of the principle of proportionality. It is unclear (how to assess) to what extent proportionality can be applied by banks in terms of depth and speed of individualisation, assessment, incorporation, management and reporting of ESG risks.
- The principle of proportionality does not only relate to size and the complexity of banks. It relates to a great extent to the materiality of ESG risks resulting from the business model and kind of counterparties. Signalling size as the only driver for assessing ESG Risk proportionality should be avoided. Assuming that large or smaller banks are more or less vulnerable to ESG risks simply because of size is not accurate. It is important that other criteria are taken into account such as business model, geographical location, as included in paragraph XX of the discussion paper.
- The EBA is invited to give more clarity on how proportionality can be achieved both with regard to requirements imposed on institutions' risk controls as well as with regard to supervisors' assessment of these control frameworks. Institutions and supervisors

can only take into account the principle of proportionality in practice, if there is a clear and precise framework that is proportionate itself. Rules on the quantification of ESG risks should not go beyond the legitimate objectives pursued by the legislation at issue and should not exceed the limits of what is appropriate and necessary to achieve those objectives.

- It is important that the supervisor considers the different degree of maturity of the labour and environmental legislation and standards of the geographies in which financial institutions operate. The consideration of ESG risks in the SREP should not reduce the financing possibilities of the economies of developing countries in which some financial institutions operate, or put these at a disadvantage compared to local entities or unsupervised entities or hinder the diversification of European banks.

Lastly, we reiterate that any framework developed by ECB should be consistent in contents and timing with the EBA's framework.

27. Are there other important channels (i.e. other than the ones included in chapter 7) through which ESG risks should be incorporated in the supervisory review of credit institutions?

We consider chapter 7 of this discussion paper to cover all relevant channels, through which ESG risks should be incorporated in the supervisory review of credit institutions.

Annex 1

28. As an institution, do you use or plan to use some of the indicators and metrics included in Annex 1? If yes, please describe how they are used in relation to your ESG risk management approach.

We agree that ESG risks need to be identified through qualitative and quantitative indicators. The non-exhaustive list of ESG indicators provided is an important starting point to obtain information on ESG related issues, and they can form the basis for the development of product offerings, and some banks have considered them as part of product taxonomy development (separate from a risk taxonomy of sectors). **However, most of the indicators are not necessary suitable for risk management and are difficult to be evaluated and applied especially outside the EU.**

29. If relevant, please elaborate on potential obstacles, including scope of applicability, granularity and data availability, associated with the indicators and metrics included in Annex 1.

The potential obstacles with regard to the non-exhaustive list of ESG factors, indicators and metrics, mainly point at the issue of **data availability**. Better availability of corporate and retail data will be a key factor for adequate banks' risk management, for the development of new financial products and for helping consumer and businesses to transition. Available, audited, reliable, and standardized environmental and social data (E&S) and non-E&S data on clients are a prerequisite for the development of quantification methodologies.

There is a continuous improvement in data quality and availability. For example, data are becoming more affordable and easier to access. However, for all indicators and metrics, data availability and accuracy continue to be a point of attention. A few of the main challenges and considerations are as follows:

- Data could be too general. For example, this is the case when data only differentiate between sectors and not between companies. Or when the data only differentiate on country level and not regionally or locally.
- Data could be too old. Banks sometimes we have to work with data that are several years old.
- Data can be too expensive or unreliable.

- It has however to be stated that data are of course not a goal in itself. Data are used for modelling and models are unable to mirror reality for 100%. With regard to modelling and scenario developing, the lack of (historical) data also provides challenges to test the resilience of the business model or to judge the possible impact of climate-related and environmental risks and the time horizon over which these effects are expected. The use of quantitative data and models could give the false idea of actual control of reality.
- Although the developments in non-financial reporting and related legislation (like the EU non-financial reporting directive) have accelerated in the last few years, reporting and data availability is not yet at the level of the financial reporting and information. Recent disclosure legislation, such as the EU Taxonomy and SFDR, do provide more granular guidelines for disclosure. However, these are primarily focused on green assets, meaning data availability and quality for those assets might improve, but this is not the case for other non-green assets.

Lastly, we would like to remark that the Indicators in Annex I have a focus on environmental and social materiality. It would be helpful to suggest indicators that focus on financial materiality.

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About the EBF

The European Banking Federation is the voice of the European banking sector, bringing together 32 national banking associations in Europe that together represent a significant majority of all banking assets in Europe, with 3,500 banks - large and small, wholesale and retail, local and international - while employing approximately two million people. EBF members represent banks that make available loans to the European economy in excess of €20 trillion and that reliably handle more than 400 million payment transactions per day. Launched in 1960, the EBF is committed to a single market for financial services in the European Union and to supporting policies that foster economic growth.