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EBF RESPONSE TO THE EBA DISCUSSION PAPER ON THE ROLE OF ENVIRONMENTAL RISKS IN THE PRUDENTIAL FRAMEWORK

Q1: In your view, how could exposures associated with social objectives and/or subject to social impacts, which are outside the scope of this DP, be considered in the prudential framework? Please provide available evidence and methodologies which could inform further assessment in that regard.

We are of the view that it is a bit too early to consider exposures with social objectives and/or subject to social impacts into the prudential framework. Also, social risk is a very different type than climate/environmental risk, i.e. in the sense that there is no contagion arising from social risk, and have not been identified by central banks as potential systemic risks for the financial system. Besides it is also more difficult to quantify in comparison to environmental risks. However, as a general principle for the discussion on social risk, but this applies also to environmental risk, we strongly encourage to make sure that discussions at the international level keep up with the discussion in the different jurisdictions like the EU. EU banks are very advanced on the topic of ESG and this should not turn into a competitive disadvantage due to an un-level playing field.

It should first be underlined that the primary protection for social risk should be in national laws (e.g. labour code) and this is not the role of banks to compensate for insufficiently advanced social standards in some countries.

As is raised in the Discussion Paper (DP), despite the efforts towards defining social factors at the European level, references to definitions of social factors are generally more difficult to identify than for environmental factors. In this respect it is important that the Corporate Sustainability Due Diligence Directive is finalised. This will give an important indication regarding potential factors to be considered also for the prudential treatment. This is also important as a misalignment between the prudential framework and due diligence obligations should be avoided, which would result in a dual reporting burden. Social risk should be seen however as one aspect of reputational risk.

Having said that, this doesn’t mean credit institutions are not making efforts related, for instance, to human rights considering whether there are vulnerabilities when performing the client’s onboarding; or in case of operational risks, social risks could be considered as potentially captured under the current Basel taxonomy as social risks being the root cause of a fraud increase, unavailability of people, etc.

Furthermore, some social risks are included in the macroeconomic scenarios used to definite risk limitation including at regional level (e.g., stagflation risks). Other social risks may be translated into reputational risks and litigation risks (ex. Risks of impacting negatively human rights) and are also considered through operational risks as explained above.

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Therefore, we believe current assessment should be focused on exposures associated with environmental objectives and/or subject to environmental impacts. Once we have advanced in this way, we may explore exposures with social objectives and/or subject to social impacts. In this context, it is important to highlight that banks are already requesting information on minimum social safeguards from their clients.

As a more general comment, we would like to highlight that the Discussion Paper links the standard approach to smaller banks, it should be flagged not only small banks use the standard approach, even the more diversified European baking groups with international presence use the standard approach.

Chapter 4 – Principles, premises and challenges

Q2: Do you agree with the EBA's assessment that liquidity and leverage ratios will not be significantly affected by environmental risks? If not, how should these parts of the framework be included in the analysis?

Yes, we absolutely agree that liquidity ratios are not the right instruments for capturing climate risks because i) time horizons are very diverging (for example, LCR: 30days vs. climate risks, which have a longer time horizon of materialisation); ii) in case HQLA assets would receive a haircut depending on climate risks this would confuse a liquidity assessment of an asset type with a political mandate.

We should also add that any operationalisation would be technically difficult as it would need to rely on a quantification of environmental risk in sovereign exposures which represent a major part of the HQLA portfolio.

It does not mean that, credit institutions should not be prepared to identify any impact of the climate risks on liquidity risk, at the level of the risk management framework.

As regards the leverage ratio, it is not a risk-based ratio in the sense that the leverage ratio is a flat ratio based on the total exposure of the bank, not necessarily the bank specific risk profile, therefore it is not affected by environmental risks.

Q3: In your view, are environmental risks likely to be predominantly about reallocation of risk between sectors, or does it imply an increase in overall risk to the system as a whole? What are the implications for optimum levels of bank capital?

Saying whether or not there is an increase in the overall level of risk or a reallocation of risk between sectors is too premature. The answer to this question depends on a lot of factors, most importantly the policy decisions adopted by governments for their industrial policies and whether or not an orderly transition will be achieved. As highlighted by several ECB exercises, like the climate risk stress test, or the recent Bank of England Climate Biennial Exploratory Scenario (CBeS), the orderly transition supported by strong and ambitious government industrial policies is the best way to mitigate climate change risks.

On the banking side, EBF members are preparing themselves for the transition and the impact of climate change. Banks are gathering data from their customers and integrate environmental risks into their risk management frameworks. In addition, the current capital framework already addresses, at least indirectly, risks arising from climate change and other ESG risks:

- The banking industry is in the process of integrating ESG factors in their strategies, governance, risk appetite, risk and control management, in line with the ECB guide on climate-related and environmental risks and the BCBS newly published climate

risk management principles. In terms of transition risks and physical risks, there is a consensus to not consider risks associated with climate change as a new risk category but rather as a factor impacting those categories already covered by the Bank's risk management system (credit risks, operational risks, reputational risks, insurance risks, etc.). Accordingly, existing frameworks and processes are being updated to integrate climate risk factors and ensure that their increasing importance is properly taken into account

At this point, we would advise against using pillar 1 measures to address climate risks, which must remain risk sensitive. On top of that, such a blanket approach would not allow to differentiate the risk between counterparties at sector level according to their transition plans. In addition, it should be kept in mind, that there are challenges to data that need to be overcome, as well as methodologies that need to be further developed (e.g., accounting for the interconnections in the value chains).This is also why at this moment, supervisors and regulators should be very careful with imposing capital through the pillar 2 framework, even though we generally recognise that Pillar 2 is the best way to address climate risk, because the pillar 2 framework for a tailored supervisory assessment on a bank-by-bank basis, relying on the SREP process. However, if a Pillar 2 add-on is imposed this should be done in the cases where banks have really a material deficiency in managing climate risk and softer measures have failed to address this deficiency on the side of the bank.

Regarding the use of stress testing, we consider that is not the right approach to calibrate climate-related Pillar 2 requirements. Climate stress testing and scenario analyses are very useful tools to apprehend changes in business models that banks will need to undertake in climate scenarios. Climate scenarios are not designed, like traditional stress test scenarios, to measure losses, and thus capital, in adverse macro-economic circumstances. Indeed, some sectors or players in sectors can be expected to benefit from climate change. The same holds true of some banking activities supporting the transition to a decarbonized economy, which will benefit in transition scenarios. Climate scenarios are designed to anticipate sectorial changes that climate change will trigger and to help banks adjust to these changes as a result. The horizon of climate change and of climate scenarios is also radically different from that of capital sizing stress tests. There are various initiatives to develop climate scenarios, such as those developed by the NGFS or the IEA. These initiatives are welcome and contribute to the development of climate scenario analyses. However, they are still incomplete and in particular do not offer a complete scenario framework where, starting from a climate scenario, industrial and technological developments as well as their translation into macro-economic variables are modelled and projected. Until this is achieved, scenario analysis will remain exploratory and hypothetical in nature or even unrealistic on short-term horizons and not suited for capital sizing stress testing.

What should be avoided in any case is to add another macroprudential buffer. The priority should be to assess environmental risks on a bank-individual basis pursuing a more granular approach, in line with portfolios, business model and strategy. Any proposal for a macroprudential tool should be preceded by an assessment as to why a macroprudential tool would be the most effective solution only once the microprudential space would be clarified and while avoiding the double counting of risk. A macroprudential buffer would not be consistent with the nature of climate risk, which is forward-looking in nature and should be assessed on bank-by-bank basis taking into account how individuals banks include climate risks in their risk management framework and can assess climate risk through stress testing in a forward-looking manner.

With respect to the optimal level of capital, we consider that there is at this point no need to increase the level of capital. Although the result has some caveats, the result of the

ECB climate risk stress test has shown that banks can absorb the impact and that banks are currently sufficiently well capitalized.

Q4: Should the 'double materiality' concept be incorporated within the prudential framework? If so, how could it be addressed?

As has been highlighted in the EBF response to the EBA's consultation on ESG risks from 2021, the following considerations are relevant when considering double materiality:

While we support the double materiality for non-financial reporting purposes, 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. 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 position of the counterparties.

Q5: How can availability of meaningful and comparable data be improved? What specific actions are you planning or would you suggest to achieve this improvement?

From a banking system point of view, specific activities by single banks (engagement) should act as refinements on a sound and robust data layer that should be built through Pillar3, ESAP, and CSRD and also by way of standard simplified templates for SMEs. It would be important to build on data that is already available through some providers, such as EUROSTAT, ENEA (mainly for EPC), JRC, CMCC Foundation, EIOPA pilot dashboard on natural catastrophes and others, like ORX consortium for operational risk. In the same sense, it could also be beneficial if regulatory and supervisory institutions were to collaborate with research organisations to move this objective forward. This is important, as banks may go beyond the information disclosed through Pillar 3 and CSRD, if other type of information could be used to support the modelling of risks. In this sense it could also be useful if regulators were to provide some guidance on the development of those proxies to ensure harmonised and comparable standards.

Nonetheless, banks could embed in their ESG strategic plan an engagement strategy (although it is very important to note that this is not feasible for companies that are not publicly listed), based on specific ESG advisory services and/or product offerings in order to get, leverage and deliver high-value insights into companies' ESG data.

However, banks are already facing significant challenges related to data due to the following reasons:

- Data protection national laws: In case of EPCs, this information is only available in some jurisdictions only to i) the owner of the EPC or ii) a third party in case of having the owner's approval. That means even being available data, its use is not warranted.
- Regarding EPCs, there is also an urgent need for consistency and harmonisation at EU level. Furthermore, due to EU Taxonomy, energy efficiency has to be proven by EPC documentation. For EPCs, there is a huge data gap as well as lack of experts to provide sufficient documentation for the already booked transactions on the balance sheet. Additionally, it is relevant to mention that energy certificates are not used in many jurisdictions outside Europe, which can make its use for risk weights very challenging for global financial institutions. For data availability, a central European governmental initiative is needed to collect standardized data (at least within Europe).

- In addition to specific Pillar 3 data, financial entities could face difficulties in extracting ESG data (insufficient company disclosure, disclosure that may not be structured or easily gathered). This has been highlighted recently with the publication of reference information to the EU taxonomy (publication of eligible activities by EU companies subject to NFRD). Vendors / Data providers also may have the same difficulties
- International cooperation and initiatives should be strengthened so that banks can ultimately rely on available quality data from their non-UEU counterparties and meet the requirements of the ITS on Pillar 3 disclosures of ESG risk
- ESG data providers should be audited and supervised. They should also enhance the quality and the transparency of their disclosures, in particular if they use proxies in their assessment (in which case, they should clearly indicate it and specify with the methodology they used)

Generally, we would expect and appreciate further guidance by the EU institutions, most notably:

- On the standardised assessment of GHG emissions
- The use of low-quality data is a key challenge that would benefit from further guidance
- On the development of proxies
- On sovereign exposures

Finally, we consider that there is a general improvement of disclosure frameworks needed, which we think should also be pursued at the global level. Open-source initiatives to provide both reliable and normalized data could be promoted by governments and institutions, in order to open up time and resources for analytical work.

In addition to have further guidance on the above mentioned issues, it would be important to have member states commit themselves to further harmonization, improving homogeneity and availability of the EPCs, because as stated in this question, even when EPCs are available they cannot always be accessed due to national data protection laws.

Q6: Do you agree with the risk-based approach adopted by the EBA for assessing the prudential treatment of exposures associated with environmental objectives / subject to environmental impacts? Please provide a rationale for your view.

We overall agree with the risk-based approach adopted by the EBA for assessing the prudential treatment of exposures associated with environmental objectives / subject to environmental impacts. This of course also means that the taxonomy has its limits for the prudential treatment considering that the taxonomy was not intended as a risk management framework.

One remark that should be highlighted here is that banks have developed privileged relationships with their clients and can have access private information which can benefit the assessment of their risks profile. Therefore, the risk-based approach should include sufficient flexibility for banks to exercise judgement and account for factors that mitigate risk. This would be a useful complement to the approach of the EBA Discussion Paper, which seems to rely to a large extent on academic research with respect to more externally observed correlations of environmental factors and risk.

Q7: What is your view on the appropriate time horizon (s) to be reflected in the Pillar 1 own funds requirements?

Our view on the appropriate time horizon (s) to be reflected in the Pillar 1 own funds requirements is the following. The issue of Time Horizon(s) for the quantification of the Pillar I risk is sensitively complex because if the horizon is stretched by 20-30 years, the quantification turns out to be much less precise and it can also be a source of potential errors and unintended consequences. On the other hand, the quantification estimated on a very long-time horizon, but that would be applied in a shorter term scenario seems to be too conservative and more related to a stress-test exercise. Generally, it does not seem feasible to adjust the current time horizon of the prudential framework, because it would entail a recalculation of PDs, LGDs, EADs, and ultimately capital requirements, which could significantly reduce their comparability.

In practice, the counterparty rating as an outcome of the rating model can be overridden based on expert opinion as to the longer-term view on the sector and the specifics of company (strategy, transition plan, risk, estimated financials ...).

As noted earlier, the best way to address the specific time horizon of climate risk is via scenario analysis, which is a good tool to understand environmental risks, considering their forward-looking horizons. Stress testing and scenario analysis, which can be used as an input to the SREP, allows to go in depth in a bank's situation and analyse where a bank might have material exposures taking into account the risk management framework of climate risk.

Q8: Do you have concrete suggestions on how the forward-looking nature of environmental risks could be reflected across the risk categories in the Pillar 1 framework?

As mentioned above, PDs, LGD and EADs are based on short time frame to capture concrete risks with sufficient certainty. Including forward looking approach in those metrics and models would mean relying on a scenario, whereas scenarios are general trends with a high level of uncertainty.

However, it does not mean that no forward-looking approach at all will be included in the credit analysis. The credit institutions should consider scenarios in the context of identifying the counterparty exposed to the environmental risks at the stage of the loan origination and assess the level of that risk under those scenarios, also progressively taking into account the transition plans of clients, as soon as they become available. The results of long-term scenarios should be used to influence strategic decisions and management actions. They should not be used to derive internal capital requirements

Therefore, forward-looking approaches are most useful where an exercise is based on different scenarios.

Chapter 5 – Credit risk

Q9: Have you performed any further studies or are you already using any specific ESG dimensions to differentiate within credit risk? If so, would you be willing to share your results?

We consider this question is best answered by the institutions themselves.

Q10: What are the main challenges that credit rating agencies face in incorporating environmental considerations into credit risk assessments? Do you make use of external ratings when performing an assessment of environmental risks?

We understand that the question is directed to credit rating agencies. Therefore, our answer is from the perspective of users of ratings and as rated institutions. Moreover, our comments are largely about ESG ratings, but we still consider those considerations as important as ESG ratings will likely be integrated at some point into credit ratings.

Rating agencies' reports on a given client or sector – where available – are part of the information gathered and considered as part of the internal risk assessment. However, members of the EBF have encountered the following points where improvements would be important:

- Credit rating agencies used methodologies to include ESG factors which could be questioned. While ESG factors should be included (under the ESMA guidelines), we observe that the methodologies are at an early stage and should be controlled due to their simplicity. Some credit rating agencies only take into account a sectorial approach: for instance, social risks are always considered as impacting negatively the credit rating of banking sectors.
- Lack of transparency on the methodologies used by providers to develop the ESG ratings. Same transparency as the one defined for credit institutions internal ratings should be required to ESG rating providers.
- Backward looking perspective for most assessment and excessive focus on ESG disclosures rather than evaluating ESG strategic considerations.
- Limited transparency on raw data used to drive ESG sub-scores (and ultimately the overall ESG Rating).
- Differences in the ratings provided by different providers to a same company
- Selection of peer groups (size, listed/non-listed) is normally not done by sectors.
- Potential instances where ESG rating providers can take advantage of being the only provider in a specific segment
- Potential for conflict of interest when the ESG ratings provider also offer consulting services on the ratings
- Supervision and audit of credit rating agencies, including a review of the integration of environmental factors in credit ratings, could play an important role in enhancing the quality and the comparability of CRA disclosures, all things which would ultimately help banks make the best use of those disclosures.

Generally, we also agree that the increased availability of quality ESG-related data on the market will allow CRAs to better challenge CRA credit risk analyses leading to enhanced due diligence.

Q11: Do you see any challenge in broadening due diligence requirements to explicitly integrate environmental risks?

The regulation (in particular 'Guidelines on loan origination and monitoring') requires that institutions are involved in this process of collecting information about the climate-related and environmental issues. Moreover, according to article 79 (b) CRD, which is referenced in the discussion paper, we understand that banks are required to collect additional information, which is not reflected in the ratings. Therefore, we consider it important to reflect on client due diligence as well.

Client due diligence is already adapting to the need to capture climate and environmental risk dimension. This reflects both internal risk management considerations as well as debt and equity investors' increased awareness and sensitivity to this risk dimension.

The gradual increase in client C&E related disclosures (be it government mandated or voluntary) – and trend towards greater standardization and comparability of disclosed metrics / KPIs – is expected to increase the consistency of C&E risk assessments, and resulting insight gained through it.

In many cases, environmental data is not available by the client, central databases or external data provides. The regulatory and/or market standard for data requirements is fast developing. Especially, private clients do not have the knowledge nor the financial capacity to provided audited documentation on environmental risks (e.g. for their real estate). Additionally, to this, there are currently not enough experts in the market to cover all these data requests (e.g. proofing EPC by inspections or calculation of energy supply for solar panels).

Many data points have to be estimated on portfolio level based on national or regional averages. Beside the underlying model risk, this bears also reputational risk for a bank since interpretations have to be made on firm-level could without any guidance by regulators. This increases the risk of unintended reputational issues, such as the accusation of greenwashing.

Another challenge currently relates to overlaps to existing requirements, e.g. value chain assessment in KYC.

Q12: Do you see any specific aspects of the CRM framework that may warrant a revision to further account for environmental risks?

We believe that the current CRM framework does not need modifications to further account for environmental factors, whether with a positive or negative impact.

- For Unfunded Credit Protection (UFCPs) environmental factors will be progressively incorporated by CRAs in credit ratings and so in the guarantor's risk weight, which is reviewed by banks and possibly adjusted to further take into account those factors as part of their due diligence requirements
- For collateral (other than immovable property which is covered by a specific framework), we deem that current re-valuation requirements of EU prudential framework are sufficient to account for environmental factors.
- As data and methodologies improve over time, the reflection of environmental factors will be naturally enhanced in collateral valuation and, as discussed in the previously, via a strengthened due diligence.

Q13: Does the CRR3 proposal's clarification on energy efficiency improvements bring enough risk sensitiveness to the framework for exposures secured by immovable properties? Should further granularity of risk weights be introduced, considering energy-efficient mortgages? Please substantiate your view.

We support the clarification being discussed right now that among member states that in case modifications are made to the property which improve the energy efficiency the value cap does not apply[1]. As a result, the monitoring and potential re-valuation will generate a

[1] "The value of the property can exceed that average value in case of modifications made to the property that unequivocally increase its value, such as improvements of the energy efficiency"

valuation enhancement resulting from energy efficiency enhancement. However, to allow for the most precise and thus risk-appropriate value to be assigned to immovable property, the proposal should be amended such that banks may apply a market value concept. In general we are of the view that if the EU wants to boost energy efficiency especially for low-income private household, prudential treatment will not be sufficient to address this issue. Political measures are needed to support this crucial and urgent need.

Q14: Do you consider that high-quality project finance and high-quality object finance exposures introduced in the CRR3 proposal should potentially consider environmental criteria? If so, please provide the rationale for this and potential implementation issues.

It should be noted that HQ Object Finance and HQ Project Finance exposures benefit from an enhanced due diligence to ensure that financial risks are adequately covered. This include the analysis of environmental factors. A risk-based approach should be followed and double-counting should be avoided. Environmental topics, with the transition and physical risks, would be best considered within the cash flows projections of the borrower when possible, and within the risk assessment of the transaction. There should not be an adjustment factor on top of other factors of selection of High-Quality transactions.

Therefore, we think that it would be unnecessary to add environmental criteria for the eligibility to the sub-asset classes HQ Object and HQ Project finance since environmental factors are sufficiently taken into account due to the very nature of these activities.

Q15: Do you consider that further risk differentiation in the corporate, retail and/or other exposure classes would be justified? Which criteria could be used for that purpose? In particular, would you support risk differentiation based on forward-looking analytical tools?

As stated in the discussion paper, simplicity and risk sensitivity need to be balanced. However, if the objective is to integrate environmental risks, while risk differentiation in the corporate exposure class may probably be justified, it cannot be done only at the level of a sector but at the level of the counterparty as it has been done in climate stress tests. Indeed, if the sector can give a good indication of clients that are more exposed to environmental risks, it is not sufficient to assess the real risks: it can depend on many parameters like the commitment of the client to transition, its cost of production etc. It should also be reminded that except for real estate financing, there is no risk differentiation across exposures in the SA framework based on risk drivers (e.g. size, gearing for unrated corporates) or risk mitigants (physical collateral) which are easier to access and to assess that environmental factors. It is unclear why and how environmental factors should be implemented as differentiating factors, if for instance creditworthiness itself is not even reflected in the first place.

As mentioned above regarding the incorporating of a forward-looking perspective, the risk differentiation across corporate counterparties can be better assessed over the medium term based on expert opinion in a first stage, subject to a long-term view on the company that includes an analysis of its transition plan. Scenario analysis could be a useful instrument as well to understand the risk profile of different counterparties.

Differentiation in the retail class would be more challenging and perhaps too complex.

Q16: Do you have any other proposals on integrating environmental risks within the SA framework?

We have not identified risk-based considerations that would allow changes to the SA framework.

Q17: What are your views on the need for revisions to the IRB framework or additional guidance to better capture environmental risks? Which part of the IRB framework is, in your view, the most appropriate to reflect environmental risk drivers?

In our view, there is no need for revision to the level 1 IRB framework. There should be ample flexibility for banks to integrate environmental risks into IRB models where relevant. Banks have the best understanding of their customers' risks and can already adequately integrate these risks in their models under the current framework, for example, in the form of rating overrides. The cases in which this risk is significant can be reflected in rating and funding decision, credit pricing and/or loan duration. This would also avoid the modification of the formula (e.g. the correlation coefficients), which would be very difficult to implement and which could imply double counting of risks, since the best way to integrate these risks is within ratings.

In addition, supervisory expectations on banks' stepwise implementation of the C&E factors in their IRB approach should be further elaborated. The approach should be flexible but there should be sufficient clarity on timeline and expectations.

Current EBA Guidelines on PD and LGD estimations (EBA/GL/2017/16) were drafted more suitably for High Default Portfolios so that many requirements are designed for statistical models. In particular, the lack of observed data ends in substantial margin of conservatism. This makes it difficult to capture the risk associated with environmental criteria that are not substantiated by a sufficient number of observations. Therefore, EBA Guidelines would deserve an update to recognize expert judgement to a greater extent.

A good way to work on the integration of environmental risks would be through setting up industry workshops/roundtables, where those issues can be discussed in a dedicated setting.

Q18: Have you incorporated the environmental risks or broader ESG risk factors in your IRB models? If so, can you share your insight on the risk drivers and modelling techniques that you are using?

Q19: Do you have any other proposals on integrating environmental risks within the IRB framework?

Q20: What are your views on potential strengthening of the environmental criterion for the infrastructure supporting factor? How could this criterion be strengthened?

The infrastructure supporting factor is an important feature of EU regulation and should be maintained as it is to further promote the development of infrastructure projects. There is no need to change the infrastructure supporting factor in consideration of environmental aspects, due to the following reasons:

- Generally, environmental topics, with the transition and physical risks, would be reflected in the cash flows projections of the borrower when possible and in the rating and LGD. This would be the best way to achieve a relevant approach, without double counting of these risks

- The infrastructure SF already includes criteria regarding the resilience of the project which itself derives from revenues, cash flows and thus capacity to pay debt service over the life of the asset, which thus will take into account transition and potential physical risks when possible. We believe that it is better to keep it focused on the credit risk aspects which themselves will include potential transition and physical risks, rather than adding separate ESG criteria
- Adding additional constraining criteria in the Infrastructure SF would not make sense as it would penalize transactions benefiting from it while other loans, to corporates or to other projects not eligible to the Inf SF would not have these constrains

We consider that the EBA approach for a risk-based treatment is adequate. In this sense, we would strongly advise not to link the infrastructure supporting factor to the taxonomy, as is currently under discussion in the EU banking package. This would also be more in line with the original purpose of the factor.

We should here distinguish between:

(i) Environmental risk considerations which should be assessed like any other project financing, and
(ii) Consideration of environmental contribution which is not led in the text by risk consideration.

Q21: What would in your view be the most appropriate from a prudential perspective: aiming at integrating environmental risks into existing Pillar 1 instruments, or a dedicated adjustment factor for one, several or across exposure classes? Please elaborate.

Generally, as we have mentioned also in the previous questions, we do not support an adjustment of the Pillar 1 framework, as we do not consider this the best approach to address climate risk. In case the EBA plans to introduce an adjustment factor, it should be risk based.

Moreover, while we do not agree that a revision of the Pillar 1 framework through a sustainable adjustment factor is the best approach, we consider it is preferable that banks, regulators and supervisors work together to develop the methodologies that can include the forward-looking aspect of climate risk and long-term horizons in the risk management framework.

Banks are part of the solution to achieve the objective of net-zero greenhouse gas (GHG) emissions in the EU economy by 2050 but they should not be the primary enforcers of the EU climate policy. There is a political responsibility in defining the relevant industrial and tax policies that could ensure an orderly transition and limit transition and physical risk levels, for both climate and financial stability purposes. This was rightfully exposed by the Bank of England in its statement: "regulatory capital cannot substitute for government climate policy"[2]. In this context, the pre-requisite to any comprehensive bank supervisory treatment (by way of Pillar 2 capital or otherwise) of climate risk will be the definition by the European Union of a detailed transition path towards a decarbonized economy by 2050 at a granular level, by industrial sector and by country, taking into account the industrial implications of a successful transition. A key aspect of banking supervisory assessment

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[2] Climate-related financial risk management and the role of capital requirements, Bank of England, PRA, 28 October 2021

should also be and remain the assessment of banks' risk management framework of climate risk and the insertion of climate risk-related considerations in decision making processes, in particular credit origination. The assessment of climate risk management frameworks and of the adherence to well defined transition paths by public authorities should form the basis of supervisory work; in case of deficiencies identified on either count, supervisors could take corrective measures, by way of Pillar 2 capital measures or otherwise.

We believe that non-risk-based Pillar 1 adjustments, such as the Brown Penalizing Factor would be pure political measures. These latter should be addressed through public policies or taxes and not through banking regulation. In addition, a non-risk-based approach would be counter-productive in terms of risks and transition finance. A good credit is not always sustainable; sustainable investments can be bad credits. That's why we support all the 'cons' presented by the EBA in the Discussion Paper and we insist on the key point that prudential capital should be data-driven and risk-based.

Lastly, in a globalized economy, punitive changes to EU banks' prudential requirements would only result in a substitution of the financing, which will be taken over by non-EU banks and/or non-bank players, subject to less stringent regulatory standards. This may put the related risks beyond the reach of EU regulators and supervisors.

Q22: If you support the introduction of adjustment factors to tackle environmental risks, in your view how can double counting be avoided and how can it be ensured that those adjustment factors remain risk-based over time?

Chapter 6 – Market risk

Q23: What are your views on possible approaches to incorporating environmental risks into the FRTB Standardised Approach? In particular, what are your views with respect to the various options presented: increase of the risk-weight, inclusion of an ESG component in the identification of the appropriate bucket, a new risk factor, and usage of the RRAO framework?

We do not believe that increases in the risk-weights are justified since we would expect that if climate related risks become relevant they will become largely reflected by the current assignment of risk weights – in the sense that RW for credit spread risk depends on the rating of the corresponding issuer, which we expect to incorporate information on climate exposure at least during the upcoming year, in line with the time horizon for pillar 1 requirements. And the calibration of the rest of the risk weights, such as Interest rate, foreign exchange, should be sufficiently conservative to account for any increase in volatility stemming from climate risk related consideration.

We also do not believe that additional bucketing should be performed on the basis of ESG variables. The reason is that such a classification would no longer be risk based, and it would likely require future changes to the regulation down the road, since either practically all underlyings will have transitioned into more favourable ESG scores at some point in the future, or the distinction will mean something different than what it means today.

Q24: For the Internal Model Approach, do you think that environmental risks could be better captured outside of the model or within it? What would be the

challenges of modelling environmental risks directly in the model as compared to modelling it outside of the internal model? Please describe modelling techniques that you think could be used to model ESG risk either within or outside of the model.

We believe that environmental risks can be captured within the current framework, as some banks are doing. Current stress periods contain elements of considerable financial stress for the relevant underlyings of bank's portfolios (if they did not, they would not satisfy the required ratios of full and reduced expected shortfalls). For ESG underlyings, that did not exist during the stress periods, proxies may have to be constructed to populate these series during the stress periods, but this can be achieved in the current framework since proxying based on relations to current risk factors is allowed as long as it is justified statistically.

If ESG-linked products become prevalent, the liquidity horizons assigned to these underlyings would need to be adjusted. Currently they would probably be classified as "other commodities price", which have a punitive liquidity horizon and which would clearly produce a disincentive for trading ESG-linked products.

Generally, we think the framework as it is works fine and we do not consider that there is a need to adjust the regulation, which could limit the flexibility that banks currently have in incorporating the environmental risk factors in their market risk management. This will allow banks also to gain useful experience and develop best practices.

Q25: Do you have any other proposals on integrating environmental risks within the market risk framework?

We believe that the Pillar 2 framework is better equipped to capitalise environmental risks in cases where there is a material deficiency in the risk management framework and all other supervisory measures have failed to address the problem on the side of the bank. Banks should quantify internally the capital charges related to environmental risks that are not properly capitalised under the Pillar 1 market risk framework. In addition, internal stress tests are better equipped to capture the longer-term characteristics of environmental risks.

It is also important to highlight those changes to the Pillar 1 would need to be consistent across jurisdictions (e.g. changes to the BCBS market risk text would need to be effected in parallel) to avoid an uneven playing field. It is more efficient to incorporate new guidance in the Pillar 2 framework as the identification and quantification of environmental risks evolves.

Chapter 7 – Operational risk

Q26: What additional information would need to be collected in order to understand how environmental risks impact banks' operational risk? What are the practical challenges to identifying environmental risk losses on top of the existing loss event type classification?

We welcome the EBA's approach by which climate-related risks are not a new category of risk but drivers of existing risks. Therefore, we consider the existing operational event types to be sufficient, as they cover types of events that may be caused by climate/environmental risks.

Practical challenges relate to:

- Identification taking into account certain info that is not routinely captured in the event logs, only in case the most relevant ones.
- Lack of automatization when using data.

- The use of operational risk taxonomies different from the regulatory existing ones may create overlaps or confusion, including the development of banks' internal systems
- Quantification, as access to climate data and forecast possibilities are limited
- The identification of the right kind of information that helps to capture the operational risk losses due to environmental factors (including the development of potential proxies, considering that there is not yet established historical information)
- Collecting information at subsidiary level to capture operational risk losses that can be used for meaningful comparisons, because the work being performed on sustainability is not always comparable across countries or developed at the same pace, and this could hamper the comparability of the information collected.

Q27: What is your view on potential integration of a forward-looking perspective into the operational risk framework to account for the increasing severity and frequency of physical environmental events? What are the theoretical and practical challenges of introducing such a perspective in the Standardised Approach?

The Basel Committee has opted for a pillar 1 treatment of operational risk that determines the OpRisk capital requirement based on P&L figures instead of actual (operational) risk metrics. As there is no quantification of actual risk(s) foreseen in the SMA, it is unclear how/ why this should be done exclusively for the specific case of environmental events. Therefore, we do not think this is the time to integrate the forward-looking perspective. If a forward-looking perspective has not been integrated into the general operational risk framework, for which we have a lot more information and experience, we do not consider that it should be done with a type of risk that is very new and for which we do not have enough information currently.

In addition, applying a forward-looking approach might introduce a number of different approaches depending on the entity that will prevent having a level playing field unless a common, clear and practical approach is defined by the supervisor.

While not directly related to the forward-looking perspective, we would also like to highlight that insurance policies could be an important risk mitigant and we would encourage EBA to further investigate how insurance policies can lower operational risk losses in relation to environmental risks.

Q28: Do you agree that the impact of environmental risk factors on strategic and reputational risk should remain under the scope of the Pillar 2 framework?

Yes, we agree that the impact of environmental risk factors on strategic and reputational risk should remain under the scope of the Pillar 2 framework. Strategic and reputational risk will be best assessed via scenario analysis and stress testing.

As a general comment, it is important to also consider the flexibility that has been given so far to banks during the recent supervisory exercises, which we believe should be maintained. It is important to maintain this flexibility that regulators and supervisors were providing in terms of methodologies given the large-scale investments that banks are undertaking to develop their own methodologies and internal systems, which is a goal that should be promoted.

Q29: Do you have any other proposals on integrating environmental risks within the operational risk framework?

It is essential that the regulatory framework treats ESG as a risk theme (i.e., similar to conduct risks) rather than isolated new risk type. Banks would run into serious challenges to re-arrange risk taxonomies with many unintended consequences in risk management and reporting processes if the latter were the case. In case there are aspects where it is not yet known how to measure it or the measurement may be considered incomplete, Pillar 2 is available to complement it.

Chapter 8 – Concentration risk

Q30: What, in your view, are the best ways to address concentration risks stemming from environmental risk drivers?

We agree with the discussion paper in that an expansion of the existing Large Exposure Framework is not the correct path to address this perceived risk due to its focus on Groups of Connected Clients.

Moreover, from the relevant section of the discussion paper we understand that the potential thrust of such concentration risks is not limited to a high risk of natural catastrophes like flooding, earthquakes or wildfire, but could also potentially include steering of exposure concentrations to environmentally harmful sectors, like the mentioned carbon-intensive industries. As stated above, a preferred way to assess concentration risk will be scenario analysis and stress testing. Indeed, scenario analysis can be made under dynamic balance sheet assumptions and, as a result, assess concentrations in a forward-looking manner. Concentration at a given point in time should be complemented with analyses of how they evolve in various scenario, including taking into account the maturities of exposures.

That being said, it does not mean that the prudential regulation should set a hard limit. It should be taken into account in risk diversification policy of the credit institution.

We are of the view concentration risks are already addressed by the framework through the large exposure regime.

When considering enhancing the reporting obligation to the current LEX regime or introducing a new monitoring and reporting standard to focus on sectors or geographical areas some challenges arise:

- A classification of exposures is needed. At this stage, the taxonomy is incomplete, only those activities that contributes to environmental objectives are defined. So, it would not be possible to classify all bank’s exposures.
- A specific sector/counterparty may cover some activities that are contributing to the environmental objectives, but at the same time other activities that do not contribute to environmental objectives. Therefore, the extra reporting may not help, as expected, to understand the size of exposures of banks towards environmentally harmful activities/counterparties.
- This classification would not be risk-based. That means it could not be demonstrated that this concentration poses a greater risk to the bank.

Having said that, in case any dimension of concentration risks is not covered under the current LEX regime, other microprudential tools would be the tools for complementing the Pillar 1

Q31: What is your view on the potential new concentration limit? Do you identify other considerations related to such a limit? How should such a limit be designed to avoid the risk of disincentivising the transition?

Generally, we would argue that regulatory limits have been expanded significantly over the past decades, not having even transposed the Basel regime into European legislation yet. Adding another regulatory limit or rules would overburden the sector. Please see also our response on question 30.

The introduction of a new concentration limit could harm specific regions or sectors, impeding them to transitioning and, in addition, could lead to a restriction of financing from the banking sector, capital from other sources could be sought, including from sources not regulated or supervised.

Currently, cases of bank default caused by overexposure to natural catastrophes are not evident (if so it may be rather a topic for insurers or reinsurers). Banks' interests are to build a balanced credit and asset portfolio, taking concentration risks of all kinds into account, e.g. through a regular review of industry-specific portfolios and their idiosyncrasies.

The potential cost of introducing such a limit, i.e. building the methodologies and IT systems to monitor it according to the (to be established) regulatory rules at each bank, and proving and auditing its compliance for the entire EU banking industry risks to exceed its potential economic benefit.

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