Discussion Paper on management and supervision of ESG risks for credit institutions and investment firms

This Discussion Paper provides a comprehensive proposal on how ESG factors and ESG risks could be included in the regulatory and supervisory framework for credit institutions and investment firms. The paper identifies for the first time common definitions of ESG risks, building on the EU taxonomy and an overview of current evaluation methods. It also outlines recommendations for the incorporation of ESG risks into business strategies, governance and risk management as well as supervision.

DOCUMENTS

- Discussion paper on management and supervision of ESG risks for credit institutions and investment firms

LINKS

- Discussion Paper on management and supervision of ESG risks for credit institutions and investment firms (EBA/DP/2020/03)
- Public hearing
- News

Discussion form

The EBA invites comments on all proposals put forward in this paper and in particular on the specific questions detailed below.

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- are supported by a clear rationale;
- provide evidence to support the views expressed/ rationale proposed; and
- provide alternative regulatory options for consideration by the EBA.

Response details

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.

N/A (this question is institution-specific)

2. PLEASE PROVIDE YOUR VIEWS ON THE PROPOSED DEFINITION OF ESG FACTORS AND ESG RISKS.

EAPB considers the definition for ESG factors acceptable. The acknowledgement of the fact that factors can have both positive and negative impact is appreciated. Considering the client base of public and promotional banks (many public entities or governmental guaranteed entities), the wider recognition of ESG factors in politics and society might free up more public funds for their operations and sustainability/transition targets. Additionally, when the urgency of mitigation of potential impacts of ESG factors becomes more and more accepted by the public and the media, clients of public banks are more likely to experience positive impact from those factors in their operations, as they are important facilitators towards sustainable transition and special adaptation initiatives.

EAPB agrees to focus on the negative impact a risk may have when defining ESG risks. Both backward-looking and forward-looking analysis of ESG risks is important. However, the ESG risks need to be identified as such first. The 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 possible ESG risk which might not have been identified at an earlier stage. By changing the word 'any' to 'future' the definition becomes more forward looking and less likely to raise concerns about liabilities as a result of overlooked ESG risks.

The 'prospective' impact of an ESG factor seems to be a rather ambiguous term in the definition. ESG factors could materialize into ESG risks 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, preferably accompanied by a clearly defined forward-looking timeframe.

Clarification about the expectations related to ESG risk integration to credit risk and probability of default assessment would be appreciated. For example, given that all Local Government Funding Agencies' loan exposures are 0% risk weighted because they are granted to municipalities or guaranteed by the municipalities or central government, the probability of ESG risks to materialize as loss in institutions' balance sheet is very low.

General remark to the double materiality from the risk management-perspective: EAPB considers the implementation of a double materiality to be difficult. In this context we would propose to lay a focus on the outside-in-perspective/financial materiality since it covers in our view the main risks of a bank.

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, for the mentioned purpose of assessment and supervisory practices from a prudential perspective it makes sense to primarily look at the ESG impacts of ESG factors on counterparties. However, looking at the nature of many of the factors, negative impacts of a factor on one client/sector/industry can at the same time have beneficial consequences for other parts of the economy/environment/society. Therefore, a proper quantification of a negative impact of a factor or risk should also take into account the potential benefits generated by it. One factor or risk considered by itself might be perceived as negative, but the more holistic result of the factor could be positive. In other words, a limited focus on the potential negatives of ESG factors (for example transition risks), might actually overlook or underestimate the (larger) benefits in a wider context of the same risk materialization.

4. PLEASE PROVIDE YOUR VIEWS ON THE PROPOSED DEFINITIONS OF TRANSITION RISKS AND PHYSICAL RISKS INCLUDED IN SECTION 4.3.

The definitions of both physical risks and transition risks do not seem to be aligned with the general definition of ESG risks mentioned in the EBA Discussion Paper. An ESG risk is defined as a risk with a negative financial impact on an institution stemming from impact on its counterparties. In our opinion, events that ‘may potentially’ have a result that a counterparty ‘be negatively affected’ have a much larger scope and ambiguity to it than the ESG risks that can be identified by their negative financial impact on an institution. We strongly advise to align the definitions of physical and transition risks with the more objective definition of ESG risks.

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?

The same remark is valid here as for the previous question. The definitions for both social and governance risks seem more ambiguously defined than the definition of ESG risks. We would prefer to make these definitions more straightforward by, similar to the definition of ESG risks, referring to an incurred or expected negative financial impact for the institution.
The relation between ESG risks for the (mostly public) counterparties of public banks and COVID-19 is not very obvious or straightforward.

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.

N/A

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.

No comments on investment firms, but we would like to stress that a further distinction in the definitions and assumed risk metrics for public and promotional banks would be appreciated. The discussion paper focusses mainly on private counterparties who by the nature of their activities could be negatively affected by ESG factors. The client base of most public and promotional banks consists mainly of public entities or entities closely related to the government or guaranteed by the government (either directly or indirectly). The typical clients of public and promotional banks have a different position with regard to ESG factors than private companies. Their clients tend to be the first initiators of sustainable initiatives, by providing funding, infrastructure, advice and cooperation between public and private parties. The scenarios in which ESG factors will have a negative financial impact on these public entities are less obvious and more remote than the ones in which private companies could be negatively impacted. Clients of public and promotional banks typically initiate mitigating measures for ESG factors before they materialize into ESG risks.

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

8. PLEASE PROVIDE YOUR VIEWS ON THE RELEVANCE AND USE OF QUALITATIVE AND QUANTITATIVE INDICATORS RELATED TO THE IDENTIFICATION OF ESG RISKS.

Based on the currently available information and data, EAPB members will most likely base the initial identification of ESG risks on qualitative indicators. Qualitative indicators will provide better tools to identify ESG risks at this stage, mainly due to the fact that EAPB members can customize the scenarios in which certain risk factors could materialize under certain conditions for specific sectors, which in themselves are not very sensitive to ESG risks.

A fundamental challenge for EAPB members, perhaps especially LGFAs, is the access to data on a granular level. In some markets data on physical climate risk factors are to a certain degree available on the municipal level. However, this is not the case on the project level, especially for institutions who offer budget loans or balance sheet funding (loans toward the entire municipal yearly budget/to finance yearly investment plans, not specific projects/constructions). Where large financial institutions can (partially) rely on the NFRD to help close the data gap, this is not the case for EAPB members whose counterparties are local and regional authorities who fall outside the scope of the NFRD.

In addition, the level of analysis required for ESG risk assessment needs clarification. An exposure level (project level) analysis would become unnecessarily burdensome and challenging both for the institution and the customers (especially with budgeting loans explained in Q22). A customer level analysis would also be challenging, due to lack of available expertise, information and data in the client base of LGFAs. Therefore a portfolio based assessment (e.g. at sector level) would be most suitable and relevant.

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.

N/A (this question is institution-specific)

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.

N/A (this question is institution-specific)

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.

N/A (this question is institution-specific)

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.

N/A (this question is institution-specific)

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.

N/A (this question is institution-specific)

14. SPECIFICALLY FOR INVESTMENT FIRMS, DO YOU APPLY OTHER METHODOLOGICAL APPROACHES, OR ARE THE APPROACHES DESCRIBED IN THIS CHAPTER APPLICABLE ALSO FOR INVESTMENT FIRMS?

N/A

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 vulnerability of an institution to ESG risks will depend on the type of clients the institution provides financing to. A small institution specialized in commodity trade finance might not have the manpower to build a sophisticated ESG risk framework to mitigate and analyze the ESG risks it is exposed to. A public or promotional bank with mainly public entity clients might also have the challenge of limited manpower to set up a sophisticated ESG risk framework, but given the different type of clients a more generic analysis of ESG risks in its portfolio combined with increased interactions with clients and sectors could very likely suffice to properly identify and analyze the relevant ESG risks in its portfolio. However, data access may be a limitation for public or promotional banks.

The proportionality concept listed in paragraph 149 is important. Proportionality as described especially refers to the size and the business model as well as the complexity of the activities of the banks. But it should also apply at the transaction level, i.e. less stringent requirements should apply to smaller loans (e.g. retail).

16. THROUGH WHICH MEASURES COULD THE ADOPTION OF STRATEGIC ESG RISK-RELATED OBJECTIVES AND/OR LIMITS BE FURTHER SUPPORTED?

We suggest the EBA to provide further guidance on this question.

17. PLEASE PROVIDE YOUR VIEWS ON THE PROPOSED WAYS HOW TO INTEGRATE ESG RISKS INTO THE BUSINESS STRATEGIES AND PROCESSES OF INSTITUTIONS.

The main challenges with regard to ESG risk management also apply 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 a typical strategic planning. 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. Also, many EAPB members find it challenging to evaluate how transition risks would materialize, as most of the transition risks (i.e. market/technology transitions) are not directly affecting e.g. the local governments and social housing organisations.

The comments on "Considering the development of sustainable products" do not seem appropriate for a discussion paper that focuses on the risk side. The "ambition level" regarding ESG (inside-out perspective) should be left entirely to the bank.

18. PLEASE PROVIDE YOUR VIEWS ON THE PROPOSED WAYS HOW TO INTEGRATE ESG RISKS INTO THE INTERNAL GOVERNANCE OF INSTITUTIONS.

Before integration of ESG risks into internal governance, the impact of ESG factors on the institution must be adequately analysed. The availability of expertise to do this in small and medium sized banks is a challenge. In addition, we also remain concerned about the availability of ESG data that will be necessary in order to develop ESG-related risk monitoring metrics and management practices, and eventually to model and/or stress test them. This represents a complicated new challenge.

In principle, the comments on the role of management bodies, committees and internal control functions already correspond to existing requirements of the EBA (e.g. guidelines on lending and credit monitoring) or national supervisory authorities. Given the already existing requirements regarding the ability and experience of members of governance bodies or key employees, we do not see the need to specifically highlight ESG aspects. The existing governance framework should, in our view, be given sufficient consideration in the ESG-context. To integrate ESG-risks into the existing governance should be suitable and allowed for every institution.

19. PLEASE PROVIDE YOUR VIEWS ON THE PROPOSED WAYS HOW TO INTEGRATE ESG RISKS INTO THE RISK MANAGEMENT FRAMEWORK OF INSTITUTIONS.

The inclusion of ESG risks by itself would have a cascade effect through risk management governance, processes, and reporting. It is important that this be simply managed as another (transversal) financial risk theme, one that can influence credit risk, liquidity risk, market risk, operational risk. If formally recognised as a risk theme, it will be among the many aspects, which are integrated into governance and management.

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.

We acknowledge the importance of taking into account the E, S and G of ESG risks. Much attention is being given to both climate risks and environmental risks, where the consequences of risks materializing from S and G risk factors can be similar or more material than the E risks depending on the type of clients an institution has in its portfolio.

We ask the EBA to recognize that data access and quality is still limited, particularly with regards to Social and Governance factors. Where relevant, qualitative data should be accepted until data quality is more mature and sophisticated.

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.

N/A

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 the understanding in the discussion paper to proportionately incorporate the ESG factors and considerations into the business model analysis of credit institutions. It however has to be noted that the regulatory calendar should avoid inconsistent introduction of requirements that are based on a still developing internal methodology and both internal and external data environment.

One of the main challenges with regard to 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.

Business model specifics of various credit institutions should be duly taken into account by the EBA. For example, Local Government Funding Agencies (LGFAs) give out general budget loans to municipalities where municipal budgets and decisions are the main source of information. The current operations do not involve collecting other documentation than the budget (where the information given is on the level “New School, centre of city”, “Upgrading waste water purification plant”, etc.). The result is limited ESG data on project level, and changing the lending model would be very challenging and costly, as well as a competitive disadvantage. For LGFAs, risk assessments on the customer (municipal and/or regional) level should suffice and provide an adequate amount of insight.

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.

We conceptually understand the need for supervisory assessments to extend the horizons to take into account the impact of ESG risks at a variety of time horizons. However, given the fact that the portfolios of public and promotional banks are strongly aligned with government policy and their climate ambitions, actual materialization of ESG risks will likely be remote. Longer time horizons will introduce additional model complexity and are likely to be longer than the duration of most outstanding loans. The proportionality of the additional complexity and challenges accompanying the introduction of longer time horizons in supervisory assessments is hard to match with the ESG risks present in the portfolios of most public and promotional banks.

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.

We support the EBA's approach that ESG risks are drivers of existing risks and as such should be integrated in the existing governance framework. This is consistent with the ECB Guide on Climate & Environmental risks, while the EBA Discussion Paper provides more granular guidance. Yet, there are challenges with regard to the incorporation of ESG risks into the internal governance and 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 also depends on and is related to the introduction of more complete taxonomy and revision of the non-financial reporting directive (NFRD).

Yet, NFRD is unlikely to address the issue of lack of data for some EAPB members. For example, several EAPB members are local government funding agencies, and finance only municipalities, non-financial organisations owned by municipalities and social housing. The data availability could be an issue, as municipalities are not subject to NFRD or other non-financial disclosure requirements, i.e. if they disclose any information, it would be on a voluntary basis and not always comprehensive.

Also, ESG risks are one theme among many which may influence financial risk. Therefore, they should have an appropriate amount of consideration in proportion to the financial risk that the ESG theme represents for the institution.

25. PLEASE PROVIDE YOUR VIEWS ON THE INCORPORATION OF ESG RISKS CONSIDERATIONS IN THE ASSESSMENT OF RISKS TO CAPITAL, LIQUIDITY AND FUNDING.

We can see merit to further investigate the incorporation of ESG risk considerations in the assessment of risks to capital, liquidity, and funding. In general, it has to be stated that ESG risks are one theme among many, which may influence financial risk. Therefore, they should have an appropriate amount of consideration in proportion to the financial risk that the ESG theme represents for the institution.

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.

Based on the principle of proportionality, the EBA considers it is important that both institutions and supervisors are able to distinguish and form a view on the relevance of ESG risks, following a proportionate, risk-based approach that takes into account the likelihood and the severity of the materialisation of ESG risks. Institutions are to proportionately incorporate ESG risks in their internal governance arrangements. Supervisors are to proportionately incorporate the ESG factors and considerations into the business model analysis in order to reflect the ESG risks in the supervisory evaluation.

Proportionality in regulatory requirements and supervisory expectations must be ensured e.g. with regard to small and medium sized organisations with limited resources, both in terms of capacity and funding towards developing and maintaining sophisticated models. For example, many LGFAs are front-runners in green finance, where sustainability is integral parts of the organizations' mandates and strategies. Added regulatory burdens must not be so large that they discourage from striving to maintain this position. Constraints on capacity must be respected.

In addition to proportionality, harmonization of any future requirements related to management and supervision of ESG risks with other regulatory developments must be ensured. Mainly CRR2 art 434a and 449a (Pillar 3 disclosures), NFRD-revision and taxonomy regulation article 8. Legislation must be streamlined so that expectations towards an institution's disclosure is harmonized to avoid double work and multiple disclosures, e.g. if an organization applies the exposure method for fulfilling expectations under CRR2, this should be sufficient also under article 8 of the Taxonomy Regulation. Different methods should not be required under different regulations. Referencing between disclosure reports must be allowed. This in order to avoid excessive workload and regulatory fatigue.

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?

N/A

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.

N/A (this question is institution-specific)

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.

N/A

UPLOAD FILES

Choose File No file chosen

More information

DISCLOSE COMMENTS *

yes

no

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