

The logo for the European Banking Authority (EBA) is located in the top left corner. It consists of the letters 'EBA' in a bold, white, sans-serif font, set against a dark blue background with a subtle grid pattern. To the right of the letters, the words 'EUROPEAN BANKING AUTHORITY' are written in a smaller, white, sans-serif font, stacked vertically.

EBA

EUROPEAN
BANKING
AUTHORITY

Discussion Paper on the role of environmental risks in the prudential framework

Public Hearing

17 June 2022

Agenda

- 1) Introduction and main principles (45 min)
 - [Comments and questions](#)
- 2) Credit risk (35min)
 - [Comments and questions](#)
- 3) Other risks and investment firms (35min)
 - [Comments and questions](#)
- 4) Wrap up and closing the hearing (5min)

House keeping rules

- To avoid background noise please remain muted, unless you take the floor
- To increase audio quality please turn off video streaming, unless you take the floor
- If you would like to intervene:
 - please indicate that on Webex chat, or
 - write your question / comment in Webex chat
- Whenever intervening please identify yourself by providing:
 - your full name (unless already used on Webex)
 - name of your organisation

Introduction and main principles

Pillar 1: Prudential treatment of ESG risk drivers



Discussion Paper

- Initial analysis of the Pillar 1 framework for credit institutions and investment firms
- Focus on environmental risks
- Questions for consultation

Evidence gathering

- Responses to the Discussion Paper welcome until **2 August 2022**
- Further analysis, including on social risks

Final report

- Mandates specified in Article 501c CRR and Article 34 IFR
- To cover environmental and social risks

Monitoring of and contribution to developments at Basel level

Questions posed

▪ Fundamental questions on...

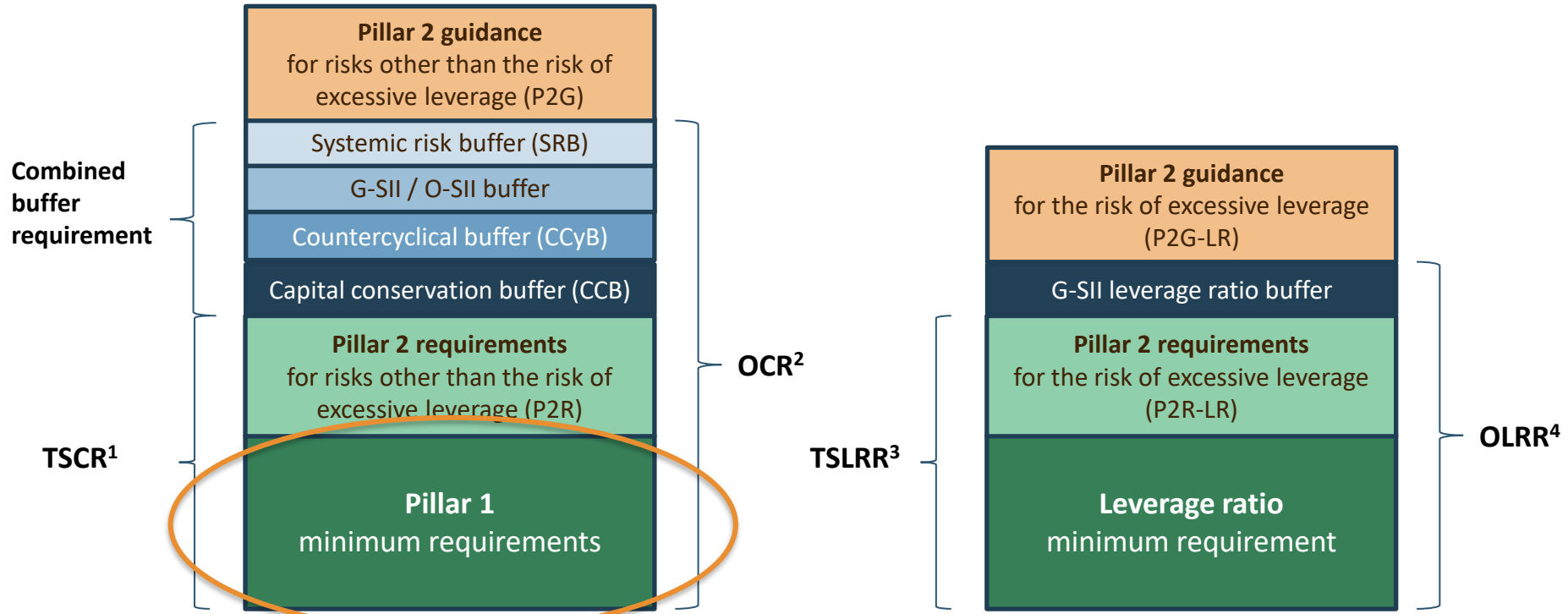
- Does the current design of the system allow for the handling of ESG risk drivers
- Will the self-updating nature of the framework be sufficient
- How to reflect forward-looking nature of environmental risks
- Overall level of capital in the banking sector

▪ Specific questions about...

- Existing mechanisms within the framework which allow capturing new risks (external credit ratings, valuations, internal models, due diligence)
- Possible targeted adjustments to the granularity of risk weights
- Potential other adjustments to the framework, including specific clarifications
- Some risks currently treated under Pillar 2 (strategic risk, reputational risk, concentration risk)
- Possible introduction of dedicated risk-weights adjustment factors

Responses welcome
until 2 August 2022

TREA and LR-based stacks of own funds requirements



Scale not meaningful

¹ TSCR – total SREP capital requirement

² OCR – overall capital requirement

³ TSLRR – total SREP leverage ratio requirement

⁴ OLRR – overall leverage ratio requirement

Principles for the analysis

■ Holistic view at regulatory framework:

Pillar 1 is only part of the overall prudential framework, other tools must also be considered, avoiding double counting and overlaps with:

- accounting framework
- supervisory activities and Pillar 2 requirements
- supervisory stress testing and Pillar 2 guidance
- macroprudential buffers

■ Environmental risks considered as risk drivers that impact traditional categories of financial risks

- Credit risk
- Market risk
- Operational risk
- Concentration risk
- Other risks

■ Risk-based approach is crucial:

- Objective to keep resilience of the financial sector against the risks
- Financial sector must remain stable and reliable to allow financing transition
- Prudential framework should not substitute other policy tools
 - ▶ policy actions in specific industry sectors can be reinforced by a risk-based prudential framework
- Own funds requirements should reflect real riskiness of exposures

Do we need supporting / penalising factors?

Pros:

- Sustainable assets to perform better in sustainable economy – theoretical anticipation of future risks and no overreliance on historical data
- Simplicity and transparency of capital impacts
- Incentive to develop screening capabilities for green assets

Cons:

- Not risk-sensitive – undermined robustness of prudential framework
- Double counting with other existing mechanisms
- Suboptimal policy measure – questionable effects as other factors at play



Green Supporting Factor

- Weakened resilience of institutions to risks
- Incentive to worsen credit standards
- Risk of greenwashing

Brown Penalising Factor

- Risk to shift to non-bank-based finance
- No support for transition finance
- Potential unintended social consequences

Preliminary conclusions:

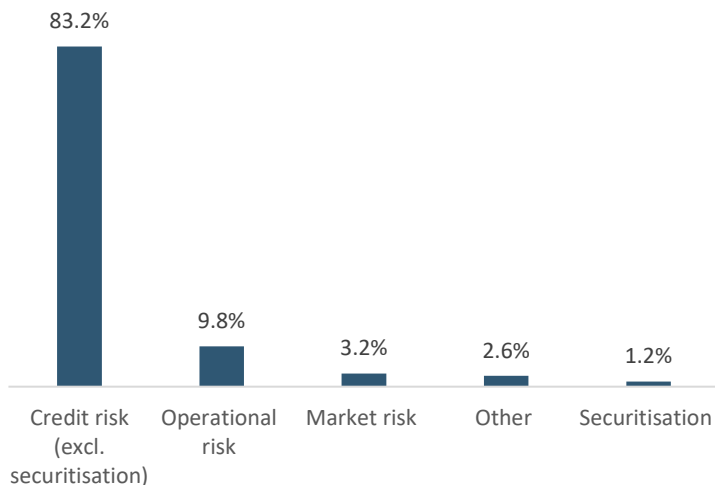
- It would likely be more accurate to reflect environmental risk through existing mechanisms in the framework or targeted adjustments / clarifications
- Further evidence is needed on the relations between sustainability and riskiness of exposures
- Any transition measures should have sunset-clauses and/or built-in phasing-out mechanisms

Main messages

- A Risk-based approach is crucial to maintain robustness of the framework
- Pillar 1 requirements do not intend to cover all existing risks – they are part of a broader overall framework
 - The most appropriate tools should be considered when addressing environmental drivers of risk
 - Should avoid double counting
- Better use of existing adaptive mechanisms and targeted amendments to the framework would address the environmental risks more accurately than dedicated risk-weight adjustment factors
- A key challenge is how to capture the forward-looking nature of environmental risk drivers
- The framework should remain evidence-based – empirical/scientific evidence is key – this will require substantial investments to enhance monitoring and measurement
- At this stage emphasis should be on collection of environmental risk-related data and development of risk management tools and practices
- The prudential framework should not tackle other policy objectives – one tool one objective rule

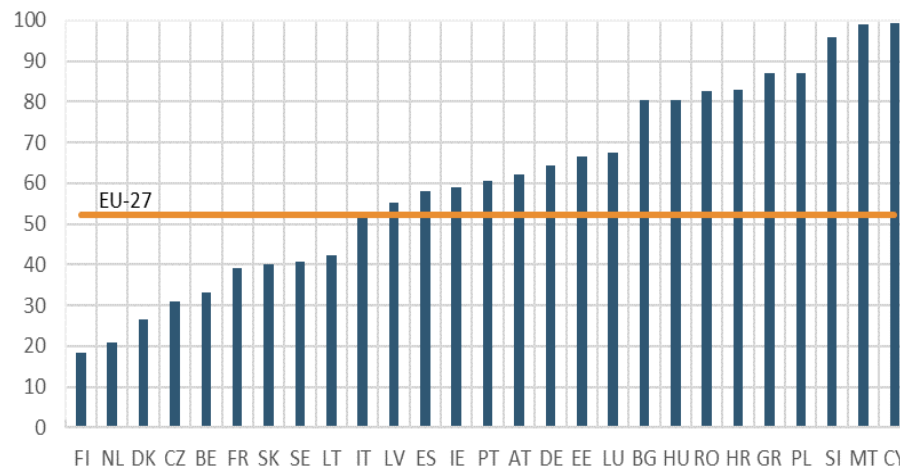
Credit risk

Environmental risk in credit risk framework



RWA composition (EU/EEA) by risk type (credit institutions only)

Source: EBA Risk Dashboard September 2021



Weight of the standardised approach in the credit risk framework
Share of total credit-risk-weighted exposure amounts derived through the Standardised Approach

Source: COREP supervisory data as of 2021 Q3, covering all credit institutions

Environmental risk drivers in credit risk framework

Standardised Approach

- **Adaptive mechanisms allowing incorporation of new risk drivers**
(level of ESG incorporation expected to increase over time)
 - External credit assessments
 - Due diligence
 - Valuation of collateral
 - financial instruments
 - immovable properties
- **Potential further considerations:**
 - Further granularity of risk weights?
 - Other forward-looking mechanisms?

Internal Ratings Based Approach

- **Internal models allow recognition of new risk drivers, subject to conditions:**
 - Model performance
 - Data representativeness
 - Possible conservatism in model application
- Value of collateral reflected in LGD estimates and regulatory LGD values
- Slotting approach for specialised lending exposures can incorporate environmental aspects
- **Potential further considerations:**
 - Adaptation of risk-weight function?
 - Other forward-looking mechanisms?

Other risks and investment firms

Environmental risk drivers in market risk framework

FRTB Standardised Approach

- **Sensitivity-based method:**
 - Existing mechanisms: requirement to apply high and low correlation scenarios (even if not historically observed)
 - To consider: further granularity of risk weight or risk factors?
- **Default Risk Charge** – considerations the same as for credit risk framework
- **Residual risk add-on:**
 - Existing mechanisms: residual risk of exotic instruments e.g. weather options
 - To consider: use of RRAO to address environmental risk by extending also to simple trading book instruments?

Internal Model Approach

- **Internal models aim at calculating capital appropriate for stress periods based on historical data:**
 - Shortfall measure at 97.5% confidence level
 - Stress scenario risk measure
- Uncertainty about the extent to which the environmental risk is already captured by market prices (expected to increase over time)
- **Potential further considerations:**
 - Capturing environmental risk outside of the model through an add-on based on scenarios not historically observed?
 - Incorporation in the existing capital adequacy stress testing programmes?

Environmental risk in operational risk framework



New Standardised Approach in accordance with Basel III accord

- Environmental factors fall within the existing categories of operational losses (e.g. physical damage, interruption of services, litigation processes)
- Capital requirements oriented historically based on:
 - financial statements (through Basic Indicator Component)
 - historical losses (through Loss Component – irrelevant if Internal Loss Multiplier set to 1 as in the Commission’s proposal)
- **Potential further considerations:**
 - Operational loss data to explicitly identify environmental risk factors?
 - Other forward-looking mechanisms?

Strategic and reputational risk

- Explicitly excluded from operational risk
- May be significantly affected by environmental risk factors
- Strongly linked to business model, strategy and activities of an institution
- Currently treated under Pillar 2 framework – case-by-case approach
- **Initial conclusions:**
 - Institution-specific risks warrant case-by-case approach
 - Pillar 2 treatment seems appropriate

Environmental risk in concentration risk framework



Large exposures regime

- **Existing mechanisms do not specifically address environmental risks but may capture some of them through:**
 - Limits on exposures to groups of connected clients (control relationships and/or economic dependencies)
 - Exemptions from LEX regime (e.g. intragroup, sovereigns, covered bonds)
- **Potential further considerations:**
 - Reporting requirements related to largest exposures subject to environmental risk?

Potential new concentration limit

- **Considerations and challenges related to design of a new limits:**
 - Single factor or various environmental risks
 - Hard limit or monitoring intensity
 - How not to hinder financing the transition
 - Need for standardised classification of both environmental impacts and transition paths
 - Impact on smaller institutions
- **Relation to the treatment of concentration risk under Pillar 2 framework** – the current treatment includes among others sectoral and geographical concentration

Environmental risk drivers in prudential framework for investment firms



General considerations

- Considerations apply to firms subject to K-factors requirements (small and non-interconnected investment firms are excluded)
- Permanent minimum capital and fixed overheads requirements are not affected by environmental risk
- Relations between the framework for banks and investment firms should be considered to ensure consistency and proportionality
- Exposure to specific risks depends strongly on the business model (activities) of the investment firm

K-factor requirements

- **Risk-to-clients:**
 - Addressing mostly operational risk and generally not affected by environmental risks
 - Reputational and strategic risk if the composition of assets under management does not account for their environmental profile
- **Risk-to-market and risk-to-firm:**
 - For firms trading on own account – considerations equivalent to market risk, counterparty credit risk and concentration risk in the framework for banks
- **Potential further considerations:**
 - Specific considerations for commodity and emission allowance dealers?

Thank you!

Responses welcome until 2 August 2022

The logo for the European Banking Authority (EBA) is located in the top left corner. It consists of the letters 'EBA' in a bold, white, sans-serif font. The 'E' and 'B' are positioned on a dark blue background with a subtle grid pattern, while the 'A' is on a lighter blue background with a similar pattern. To the right of the letters, the words 'EUROPEAN BANKING AUTHORITY' are written in a smaller, white, sans-serif font, stacked vertically.

EBA

EUROPEAN
BANKING
AUTHORITY

EUROPEAN BANKING AUTHORITY

Floor 24-27, Tour Europlaza
20 Avenue André Prothin
92400 Courbevoie, France

Tel: +33 1 86 52 70 00

E-mail: info@eba.europa.eu

<https://eba.europa.eu/>