EBA/DP/2020/03

Version: 19 January, 2021

Deadline: 3 February, 2021

BANKING STAKEHOLDER GROUP

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

General considerations

Banks and investment firms are increasingly active in developing sustainable finance instruments, to progress the ESG transition lengthy pathway, by aligning their lending portfolio with the Paris Accord, developing ESG governance, policies and monitoring tools, and assessing climate risks. In the medium- and long-term unmanaged climate risks can impact banks and investment firms clients' viability, solvency and returns potential, thus the profitability and risk of the institutions themselves.

While it is to be supported that the banks put efforts to proactively incorporate ESG factors into risk management, the BSG believes that it should not substitute necessary public policy actions either introducing targeted incentives for all economic actors to change the economic behaviour, to decrease overall risk in the economy and to foster sustainable economic development or with punitive actions by means of regulation, fines, and taxes.

Challenges and data availability

The BSG welcomes the EBA Discussion Paper (DP). The DP is balanced, comprehensive and shows a good understanding of the challenges to incorporate ESG factors into risk management. It is worth noticing that 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 carbon emissions).

The time horizon of ESG risks is longer than the regular time horizon for strategic planning. There are many uncertainties about the actual transmission channels from climate risks to financial risks, which is partly due to the absence of historical data and the need to develop forward looking approaches and methodologies**.** The BSG recommends that more research is done to enhance the understanding of ESG risks and their transmission mechanisms.

Over time the EBA expectations should be achievable, but challenges remain and must be overcome with no delay. One of challenges relates to availability of reliable, adequate, recent, accessible 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 achieve swift transition. Available, reliable, and standardized data are prerequisites for the development of quantification and forward-looking 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 expected level of the financial reporting. Recent disclosure legislation, such as the EU Taxonomy and the Sustainable Finance Disclosure Regulation (SFDR), do provide more granular guidelines for disclosure by financial institutions. 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. Mandatory disclosure from corporates will only enter into force at a later stage, and for SMEs, not subject to such disclosure requirement, gathering the necessary information may be more demanding. Additional flexibility is also needed regarding exposures of EU banks to non-EU counterparts, where EU standards do not apply, and in the absence of harmonized international rules, making data availability even more challenging. The BSG believes that EBA could play an important role in making this data accessible and comprehensive.

Also, the BSG emphasizes that the methods on how to integrate ESG risks into the risk management framework are still under construction. To properly assess the time horizon in which ESG risks could materialize and incorporate this assessment into quantitative risk management frameworks as for credit, operational and market risk, provides an additional challenge. This is already the case for climate change risks, and will be even an equal challenge for social and governance risks and their financial impacts, specially as the social risks may accelerate as a consequence of the current COVID-19 sanitary crisis.

Phase in approach

The BSG believes that a phase-in approach is necessary to progressively include those risks in banks' and investment firms' frameworks and to organise the internal processes, systems, organization, and retrieve appropriate data. Banks should be subject to a single and consistent set of ESG requirements, from disclosure to risk management. The BSG advices EBA to lead the process, establishing the definition of the ESG Risk, as well as a practicable defined calendar, since not all of the expectations and considerations in the activities and key processes can be achieved at the same time. While at some banks the Risk Management Function has already been mandated to develop internal ESG risk management framework, for others the role expected for the Risk Management Function and for the Internal Audit require a full definition of the ESG Risk, prior to adapting the internal policies and/or define skills or assign roles and responsibilities. The absence of such definition might lead to a delay in implementing the ESG requirements into risk management.

At the moment it is also not yet possible to quantify financial implications of ESG risks, certainly not in all sectors or portfolios over the short, medium and long terms. On a client level in certain cases there is more quantitative information, depending on its reporting and transparency, on specific, often sector 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 work in progress for banks, investment firms as well as supervisors. The EBA has listed and described various methodologies being developed by different stakeholders. The BSG welcomes this

effort and encourages a constructive, and inclusive dialogue between EU institutions and all stakeholders (including consumers groups and academics) about the most appropriate and practicable methods, metrics, and indicators in the short term in order to bring all ideas forward. Such a dialogue should be inclusive and allows for open discussion on the pros and cons for the exposed methodologies.

A clear distinction should be established between acute and non-predictable events (Black Swan type), and long-term trends, which have different impacts on prudential risks. In view of the challenges the discussion paper so aptly describes, the BSG recommends that regulatory requirements should be introduced using a step-by-step approach accompanied by appropriate evidence. Such approach would allow good practices to emerge, evolve and to be tested before introducing hard and fast rules. Following this approach, the inclusion of the ESG risks in the SREP process for example could focus during the first years on qualitative aspects and seek a "supervisor-supervised" dialogue/mutual learning before having quantitative implications.

Clarity on the objectives

The BSG believes that there are many interpretations in the current discussion of how to deal with ESG risks. This is partly because the objectives of rules are sometimes insufficiently clear or at least perceived not transparent enough. One goal could be to achieve or support the Paris climate targets and thus to reach greenhouse gas emission neutrality in 2050. Another might be to ensure the solvency of institutions, i.e. to measure risks very precisely and use this as a basis for allocating capital and pricing in risks appropriately. A further goal could be to identify the vulnerabilities of an institution and to draw conclusions about long-term options for actions. These objectives, which are certainly not intended to be exhaustive, might require different time horizons and different measures and methodologies. However, some of the BSG members point out that ESG factors have to be included in the entire risk assessment (ESG should be one of many input factors in impairment modelling) and therefore that the time horizon of the entire assessment is automatically relevant.

Unrecognized systemic risks

Some members of the BSG warn that there might be systemic risks to financial stability which are not recognized at all under the current ESG risks, namely, the incompatibility between certain sustainable business models alongside a debt based monetary system. Many innovative sustainable businesses rely on natural contributions to minimize human work and the necessity to invest capital in order to create goods. For instance, permaculture harnesses the "free" labour of worms, cyclical natural compost, bees, insects, natural fertilizers, ecosystems etc. These methods only require an initial investment after which the setup produces year upon year goods (fruits and vegetables) which are not capital intensive at all. If these business models are generalized to many sectors of the economy, this could ignite a systemic risk for financial stability and price stability as the monetary mass would shrink (with the reimbursement of existing loans and the lack of injection of new money through new loans to support the functioning of sustainable businesses) while the total amount of goods in the economy could increase. In essence, any good or service which enters the economy without a monetary counterpart (without the need for investment through a loan) is a liability to financial stability as it exerts a deflationary pressure on the economy. Many other sustainable

business models could have the same or similar effect. For instance, a more pervasive market for second hand goods, which is booming through social platforms, only utilizes existing money for exchanges. This factor should be taken into account in the ESG risks and monetary policy, in order to ensure that the financial system adapts to allow a compatibility with the inevitable emergence of sustainable business models relying on low to no capital investment and thus no monetary creation.

Double materiality

The concept of double materiality is fundamental to understand ESG risks: the focus is not only on a client's financial risks but also on the impact of their activities on the environment and society.

Without increased clarity on which goals are being pursued and what the focus is on, it will not be possible 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.

The BSG is of the opinion that the EBA should better differentiate between different perspectives (inside-out vs. outside-in) and different time horizons under consideration (short-term, medium-term and long-term). This will enable both objectives and measures to be categorised more clearly. Differentiation by time horizon will also address the uncertainty factor. This is always an issue when taking a longer-term view but is even more important where ESG risks are concerned since historical datasets or experience of materialised ESG factors, especially in a climate context, do not yet exist in a way that could be readily implemented with existing risk models. It would also allow to differentiate the tools to be used : for short term risks, the traditional capital framework, which is calibrated to capture 1-y unexpected loss, for the medium term, scenario analysis, at a 5-10 y horizon, and for the long term, portfolio alignment frameworks, over the timespan of the Paris accord

A more targeted approach could be advisable where the solvency of individual institutions and the reduction of systemic risk to the financial system are the focus of the EBA's Pillar 2 rules. So, the regime governing ESG risks would focus, at least initially, on an institution's financial risks (outside-in) given its complexity, and activity-based risks of a bank's customer (e.g., social or climate-related reputation risk) would be covered from the outside-in perspective first. This will make it easier to describe, identify and ultimately manage the risk driver. The "inside-out" aspect of ESG risks should not be excluded a priori from consideration in an emerging framework, however. An EBA ESG risk management framework could initially focus on financial materiality ("outside-in"), while practicable approaches to incorporating the "inside-out" perspective are further explored by regulators and experts. Applying the concept of double materiality (inside out and outside in) appears to pose fewer practical problems when it comes to disclosure and it should therefore be incorporated in the relevant framework from the outset.

Risk horizons

The framework should distinguish between three risk horizons: short-term (1-3 years) and medium (4-9 years) and long-term (10+ years).

1. In the short-term horizon, the focus should be on the harmonized implementation of ESG risks definitions, with appropriate KPIs. The BSG support that ESG risks should not be seen as a separate risk category, but rather as risk drivers, that would impact "traditional" risk types, such as credit risk (increased or reduced PD/LGD depending on counterparty ESG performance), market risk (appreciation or depreciation of value of a trading asset depending on changes in value or market perception due to ESG factors), or operational risk (materialization of a physical risk event generating an operational loss). Ideally, the information obtained should, like today, be used for capital adequacy, capital allocation and pricing purposes. ESG factors act as risk drivers and should therefore be taken into account in the time horizon (some BSG members mention, that as a consequence, to the extent that ESG factors are incorporated in a bank's risk policy and credit decision, the ESG factors should already be embedded in the risk assessment of the default risk). This can be achieved qualitatively or quantitatively. Depending on the materiality of ESG factors, compared to traditional financial risk drivers, there may be implications for loan loss provisioning or regulatory capital. Methodologically, ESG factors could be considered at individual level as part of the loan origination process (credit analysis, rating/scoring, etc.) and at portfolio level using corresponding portfolio models and scenario analysis (e.g. adverse scenario under the normative approach). They will complement existing processes. Some BSG members stress, that they will complement existing processes, while others point that the ESG factors should already be implemented within current approaches.

2. In the medium and long-term horizon, the focus should be more on strategic questions: how vulnerable and sustainable are the business models of clients and the institution itself? How should portfolios be composed for instance in 5 or even 10 years' time? What will be the default risk assessment of an existing engagement over a period of time? In methodological terms, consideration could be given to Greenhouse Gas Emission GHG measurement methods/alignment approaches (Partnership for Carbon Accounting Financials (PCAF), PACTA, etc.), ESG ratings and stress tests/scenario analysis, for example. The latter, however, use other variables and parameters than in the short-term horizon. As to the question of portfolio composition, the inside-out perspective will once again have a role to play. The additional difficulties to make quantitative analysis with such a long term horizon, for example in a stress test exercise, would make it at least very challenging.

3. The definition of the long-term horizon should be seen in the context of the bank /investment firm strategy or at the horizon of the EU policy goal to achieve carbon neutrality by 2050. While we understand it could be 10 years or more, different references are made to 2030 (more often cited), 2050 and 2100 (e.g. §2 or §314). Some BSG members would favor a definition of 10 years which already represents a considerable extension of the current 3 to 4 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.

Proportionality

The BSG welcomes the inclusion of proportionality principle in the Discussion Paper, however a concern is expressed about the linkage done between proportionality principle and the size of institutions in specific paragraphs. Proportionality is also about the systemic nature and business model of the institution. 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, systemic importance, internal organization and nature and complexity of its activities. In addition, 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. Some BSG members flag that specific vulnerability can relate to the complexity and cost of data and data handling. Proportionality should not only be considered from the point of view of the bank, but also from the point of view of the client. Requiring massive ESG data input from SMEs can be unrealistic and create a massive administrative burden, the same BSG members do not believe that the bilateral dialogue between the banker and an SME client can be an appropriate solution to gather data, as it would be completely manual and lack data quality and verification, thus exposing the bank to potential liabilities.

The BSG encourages differentiated requirements for the retail business which is of a different nature and generally includes different risks than investment business. ESG risks also affect, e.g. the retail business, mortgage loans, but in a different way. Having the same requirements regarding the incorporation of ESG risks into the risk management are usually not proportionate. There should be an adequate set of rules for it. While housing is a major source of CO2 emissions, incorporating these portfolios would require an industrialized process, based for example on Energy Performance certificate etc…

A proportionate approach should also be considered to apply in relation to the various stages of development of climate and environmental risks as drivers for the various risk types. In particular, the identification methodology of climate risks in trading portfolios may be assessed at a later stage, given the inherent short term nature of those positions. From a transition point of view, dedicated KPIs such as issuance of green bonds may be better incentives to grow sustainable finance.

Moreover, as part of the analysis of the principle of proportionality, the issue of costs should be assessed. As of today, we believe that pending the development of mature and standardized methodologies that are validated by the authorities, and pending automated and reliable data sources, the assessment of the ESG risks can be challenging and costly in particular for smaller banks.

Definition of ESG risks and factors

The definition of ESG risks in the Discussion Paper (DP) appears generally acceptable, especially in the limitation set out for "negative" impacts. However, the BSG flags that the inclusion of the word 'any' will 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' 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.

The question arises 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, the scope of counterparties' risks that banks/investment firms are able to acknowledge and manage should be limited. In other cases, considering the inclusion of all potential ESG risks across the value chain of counterparties/companies may lead to disincentive banks/investment firms to support those sectors/firms that are transitioning.

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

Social and governance risks

Identifying S&G 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 (and even then it will be rather an ordinal scale (higher or lower risk) than an actual number or amount). 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 It seems important to underline that, in the context of the COVID pandemic, financing social infrastructure, financial inclusion, etc… should be promoted, and that the EBA should encourage the Commission to accelerate the design of a Social taxonomy, as a first step toward harmonization of the definitions.

In relation to specificities associated with the management of governance risks, it is worth recognising 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

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 necessarily suitable directly for current, quantitative risk management techniques and may be difficult to apply outside the EU.

Simple, less technical scoring systems are perhaps more suited to retail audiences. Whilst advancing new and existing indicators is welcome, more sophisticated indicators and systems may prove counterproductive by deterring investors who do not have sufficient knowledge in this area to make investment decisions if the language and terminology is overly technical. ESG labeling must be simple, transparent and easy to understand.

EU taxonomy

It should be clarified that the EU taxonomy is not considered as a risk management tool in order to avoid any misunderstanding between different stakeholders. The EU taxonomy introduces an EU-wide classification system of environmentally sustainable activities and is intended to provide clarity for investors in relation to sustainable economic activities and for assessing the proportion of funding provided by financial products that is directed towards such activities, which already meet the target standards, in order to avoid green-washing. There is an expectation, however, that steering companies towards a sustainable product offering to help de-risk portfolios as companies that engages in sustainable activities may be better positioned from a sustainability/reputational risk angle. There are many other factors that can unfavorably affect its financial performance (e.g. unbalanced debt/equity structure, poor product offering, etc.). In any case, the EU Taxonomy Regulation is still under discussion, and not applicable, as the technical screening criteria needed to properly apply it are not ready yet. Only on 1 January 2022, the Taxonomy Regulation will begin to apply with regard to its climate change mitigation and climate change adaptation objectives, and on 1 January 2023, the Regulation will become fully enforceable with respect to its four environmental objectives.

Methodologies

Pending a more mature methodological basis, and availability of appropriate empirical data for incorporating ESG risks into the Pillar 1 framework the principle of methodological freedom should generally be applied in Pillar 2, which includes the methodological treatment of ESG risks. It will continue to be the task of supervisors to set an overarching framework and to continue the assessment of the methodologies in practice. It should be up to each individual institution, however, to design its own risk management strategy for internal purpose. The EBA´s flexibility on the method to be used by institutions is initially to be welcomed. However, this flexibility could also be maintained as a long-term approach, as choosing a specific methodology has significant investment implications for the development of systems. The EBA should ideally maintain this flexibility over time, or at least, provide a clear timeline with sufficient early warning for institutions to be able to update the systems and processes accordingly. However, a minimum harmonisation approach to certain methods is welcomed, as it should be avoided that banks make unnecessary investments in methods which later cannot be used for supervisory review.

Alignment methods

According to some BSG members, the understanding on portfolio alignment methods is that this relates more to strategy and business opportunities than to risk management, although 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 key to be able to balance the investment effort in these external methodologies. It is important since experience has demonstrated that the use of external

methodologies related to credit risk models has been penalized on a regulatory basis, being the internal developments the preferred options by regulators. In any case, the BSG welcomes that the EBA report keeps the door open and avoids a too prescriptive approach, which would be premature at this stage. It should be noted that some of those methods have been developed as open source by banks (notably the Katowice alliance) so that the framework can be used freely and improved by all stakeholders[1].

Risk framework methods

Stress testing is particularly challenging, and actually not yet fit-for-purpose, as relates to ESG risks. Indeed, the current stress testing framework, which requires extensive resources, notably in finding a full set of scenarios to cover both probable and rare yet possible outcomes, is limited to a time horizon of 3 years, which fits with the potential materialization of credit, market and operational losses. It is based, for feasibility reasons, on a static balancesheet assumption, which obviously is already a massive oversimplification, as it assumes that, as a crisis scenario is simulated, the bank take no management action to reduce its exposure to the affected activities.

If applied to climate risks, such a framework would be totally irrelevant : the horizon to be looked at is much longer, and given the intrinsic nature of climate risks is about transitioning or not toward a low carbon economy, assuming a static balance-sheet would negate any portfolio alignment effort, and there fore not properly discriminate among different players or underlying assets.

Climate sensitivity analysis, as the one currently developed by ACPR in France, and some other regulators, being a more relevant form of integrating climate risks into financial modelling, could be a working solution, although it remains rather complex for smaller banks, yet there is not enough experience at the market within this method.

The BSG fully agrees 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 is the case for all risk categories. It appears that banks and investment firms are currently 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. The question arises however to which extent regulators will accept the use of external provider methodologies over time.

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

[1] In December 2018, during the COP24 in Katowice, BBVA, BNP Paribas, ING, Société Générale and Standard Chartered committed to measuring the alignment of their loan portfolios with climate targets and studying their capacities for gradually moving their financial flows towards activities compatible with the Paris Agreement.

On September 2020, these banks jointly published with 2 Degrees Investment Initiative a report on the application of the Paris Agreement Capital Transition Assessment (PACTA) methodology to their credit portfolios. It is worth mentioning that PACTA is Open Source. In addition, the approach is dynamic. The analysis proposed is sectoral and was tested as a priority on the economic sectors producing the most GHG emissions: automotive, power and fossil fuels. The extension of its application to other sectors, along with the availability of the data will probably lead to further adjustments. And lastly, its adoption by banks and industrial stakeholders should also enable further improvements.

higher degree of method transparency, comparability and consistency by ratings providers or approval of specific ratings by regulators. The risk of investing into external data without being certain they meet regulatory approval is too high in particular for a small institution that will have to rely on internal developments for which capacities are lacking. Another concern in this respect is that ESG ratings are generally only available for publicly listed firms. Most non-listed firms do not have such an ESG rating available.

Integration of ESG factors in modelling and capital planning

EBA's acknowledgement of the difficulty to include ESG factors in internal credit models is welcomed. The possible future events depend on scenarios that are long-term, so they cannot be integrated directly into credit models. As long as there is a shortage of historical data for quantifying ESG risk factors, it appears likely that modelling will rely on scenario analysis, at least for the near term, and new forward-looking approaches and new methodologies will be needed given the unprecedented nature of ESG and specifically climate change (CC) factors and risks.

Banks and investment firms will have to progressively test relevant ESG factors to complete the gaps in data, methodology and 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 are also largely considered to have a longer-term impact while liquidity risk is mainly a short-term risk. The approach with regard to ILAAP (Internal Liquidity Adequacy Assessment Process) should therefore be proportionate, and the BSG recommends to develop it at a later stage.

Stress testing

The fact that EBA recognizes that stress tests are still too exploratory exercises to trigger capital requirement consequences is to be welcomed. Stress tests can give very different results depending on the methodology used, the assumptions included in the time horizon and the scenarios which will be tested (smooth convergence, rapid convergence, no convergence). EBA should specify that stress test results could only be used, even qualitatively, by the regulators provided that they have defined a common set of assumptions and scenarios.

The recommendation that institutions should leverage on the NGFS (Network of Central Banks and Supervisors for Greening the Financial System) scenarios to overcome the modelling challenges on climate risk scenarios is to be welcomed. However, it is important to bear in mind that banks/investment firms 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 finalise the task.

Similarly, the recommendation that institutions should use "multiple scenarios" to assess climate risks is questionable. This could add further uncertainty and lead to heterogeneity in outcomes

across institutions, as for now, there is no clear view on the climate pathways and year horizons etc. among other variables. One interesting approach in this area is the approach chosen by ACPR in France, where the base case scenario is a scenario of orderly adaptation to the Paris accord objectives, and the adverse scenarios are scenarios where the transition path is not met, leading to disruptive impact on the economy, brutal policy responses, and inability of most vulnerable firms to adapt.

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.

The BSG recommends 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 it is expected 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.

Pricing

The DP calls on institutions to 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 and preferably a phased-in approach after the implementation of the ESG risk management framework. The various risk management practices to manage ESG risk, which could include internal pricing mechanisms, risk appetite limits or requirements for risk reduction, may or may not always translate into external pricing of products. It should be approached holistically as part of a bank's approach to ESG risk management. Also, given that pricing is already dependent on global market forces, namely an institution's borrowing rate and a risk premium. For example, larger institutions which are active outside of Europe may therefore face a pricing, and hence competitive disadvantage if regulators outside of the EU do not adopt the same measures. Particular attention should be devoted to the United States, as most commodities are funded in US Dollars which usually means European based institutions start at a disadvantage. We would expect, however, that pricing will progressively adjust to reflect the higher long-term risk of unsustainable activities/exposures. In practice, the priority as regards to pricing has been for banks to offer lower prices to clients on green products, in order to encourage them to accelerate their transition. This is in particular the case for "sustainability-linked loans", where the interest margin varies as a function of the capacity of the corporate to achieve some contractually agreed KPIs, defined to capture whether the corporate is on track in its transition pathway.

Supervisory assessment

From a conceptual point of view, it is understandable 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, for climate the impact is predominantly noticeable in the long term (reaching up to 2050). Consequently, regulators and supervisors should not expect the same granularity of measurement at such long horizons than on traditional 1-y capital modelling tools.

The time horizon

The time horizon for a correct assessment of the ESG risks is medium-long. The current regulatory framework for management and supervision of risks, such as the SREP, is built on the short to medium term at most. It therefore seems useful to reflect on what changes are needed, even at the Level 1 legal framework, to reconcile the two different perspectives and allow banks and supervisory authorities to assess the ESG's risks effectively, and in line with regulatory constraints.

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

From an analysis of the business viability perspective, the time horizon used should be aligned with that considered within the SREP process, having also in mind that this is a review carried out on an annual basis. In order to assess any upcoming ESG risk (beyond 12 months), 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. Some BSG members believe that it might be difficult to gauge if such an assessment would then lead to credible outcome.

Given that ESG risks can materialise in the short and medium-term, paragraphs 302 and 303 provide considerations to understand the quantitative impact from ESG factors and the areas qualitative analysis should cover. It would be advantageous if the discussion paper would provide more details as to how this long-term resilience should be operationalised by credit institutions.

It is important to consider the value of geographic and sectoral diversification in the assessment of the long-term resilience of credit institutions.

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, it is essential that any framework developed by the ECB should be consistent with the EBA's framework. Also, in 2021, banks will provide for a gap analysis. This should also serve as input for the Discussion Paper outcomes.