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BBVA Response to EBA Discussion paper on management and supervision of ESG risks for credit institutions and investment firms

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

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

We have prepared an initial Internal ESG materiality map that identifies the most material E and S factors for each sector. The indicators chosen for each industry are linked to some concrete metrics. An initial cross-sector approach has been applied for G factors; even though some particularities for specific sectors are defined. The internal materiality map rests on work by the Sustainable Accounting Standards Board (SASB) and credit rating agencies´ methodologies (primarily on S&P).

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

ESG factors are defined as those that "*may have a positive or negative impact on the financial performance or solvency of an entity, sovereign or individual*". As the relevance of ESG factors for institutions depends heavily on sectors of counterparties, **a proposal of mapping between sectors and factors based on potential materiality would be beneficial and welcome**. As mentioned by the EC´s Guidelines on Non-Financial Reporting, **similar issues are likely to be material to companies operating in the same sector**.

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.

We agree with the EBA approach considering that ESG factors can have a positive or a negative impact in the counterparty, and that from a prudential perspective ESG risks should be approached primarily from the angle of the negative impacts. Having said that, **if there is empirical evidence that ESG factors can contribute to mitigate or reduce ESG risks it should also be acknowledged and reflected from a prudential perspective**.

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

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We agree on the consistency with the NGFS definition.

Nevertheless, it is important to underline **reputational risk** stemming from i) behavioural changes, in particular in relation with changes in investors preferences that are already having an impact on access to financing of industries such as oil & gas, ii) litigation, and iii) not meeting the standards of what is defined as sustainable (greenwashing).

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?

In general, the term ***"potentially be negatively affected"*** **should be defined more precisely**. More effort is needed to define governance risks in a more specific way and to define what **"poor governance"** is in a way that can be feasible to detect it in our clients more straightforwardly.

Social risks stemming from changes in consumer preferences due to changes in values and preferences can deeply affect entire segments of the food industry, tobacco and consumer products in general. More focus on these dynamics and how they can be managed by the institutions (for instance, how to implement early warning systems to detect these changes) would be of interest too.

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

A more detailed description would be welcome. There is a lack of details and specificites, especially for the S and the G. **More specific indicators** to measure, to delimit and to manage those risks would be really appreciated.

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.

We completely agree with the specificity stated in paragraph 35 with regards to the **minor relevance counterparties have in the case of investment firms since ESG risk in investment firms, asset managers in particular, comes from the exposure in the portfolio of the products and portfolios** that they manage on behalf of their clients.

The realization of ESG risks in these portfolios could impact investment firms financially through the decrease of assets under management related to the effect of such risks in the **underlying investments**. Secondly, by the **effect of these risks in the behavior of clients**, both institutional and retail, that may imply an increase in redemptions. In the long-term, they may have an impact on their competitive position versus other asset managers that have managed better these risks in their products.

Therefore, we consider definitions also apply to investment firms. **However, the impact of the realization of these risks should be considered distinctly due to its minor relevance**.

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.

The debate is in a very nascent phase. It is really welcomed that this DP aims at covering E **plus S&G from a supervisory perspective.**

It is also worth to be noted that **S&G factors and risks can significantly differ from E** (and climate-related) risks.

S factors and risks are less advanced than E factors and risks. There needs to be a more defined criterion that leads the way beyond complying with the international standards. S factors are neither horizontal nor equal for all the countries. On the contrary, they are **very local and specific at a country level** (i.e.: demography or inclusive infrastructures can significantly differ from one country to another). S factors can also have a significant **transformation ability**.

Identification of ESG risks is a mix of qualitative and quantitative indicators. For example, identification of social risk may be a more qualitative issue while climate risk can be more quantitative. As it was aforementioned, climate risks measurement is in a more advanced stage than social risks

Quantitative identification remains a difficult approach given the lack of homogeneous reporting and data to benchmark the situation of portfolios and clients in specific ESG factors.

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 risk management? If yes, please explain which ones.

So far we have i**dentified material ESG factors at industry-level**. Accordingly, we have chosen indicators/metrics to collect at **client-level** during the loan origination and client review process (including emissions data, other environmental and social indicators and emissions targets and investment in sustainability plans). We have developed **an internal transition risk taxonomy,** to identify those activities which are more vulnerable to the decarbonisation process through the policies, technology and market changes transmission channels.

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.

We are working in the calculation of the alignment of our wholesale portfolio through the PACTA approach. More specifically, we are part of the Katowice´s group of banks which has developed an adaptation of PACTA to the bank´s lending portfolios. We consider that getting our portfolio aligned to the Paris Agreement Targets is **a valuable approach to mitigate transition risks both at portfolio-level and at individual clients-level.** In that vein, we **actively engage with our clients** because we strongly believe it is a valuable management ESG risk tool (as acknowledged by the EBA and the ECB).

We are **also working with the other two methodological approaches for assessing and evaluating ESG risks considered by the EBA in this DP (the Risk Framework Method and the Exposure Method)**, jointly with the comparison of methods and their application. We broadly see the three tools can be **complementary**.

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.

We are working in the **development of a stress test and scenario analysis framework for climate risk** (transition/physic) that uses climate scenarios (based those of the NGFS) and transforms them into **provisions and capital long term impacts.**

The ECB has recently communicated that it is also currently carrying out a climate risk stress test exercise to assess the impact on the European banking sector over **a 30-year horizon**, and that preliminary results from mapping climate patterns to that address-level location of firms' physical assets show that in the absence of a transition, physical risks in Europe are concentrated unevenly across countries and sectors of the economy. It would be very much welcome if the ECB & and the EBA could work coordinatedly on this issue, and that they could share as much light and detail as possible to banks, **so we can replicate their modelling techniques to anticipate and mitigate some possible impacts**.

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.

We are currently using the **ESG evaluations of rating agencies for corporate clients** such as S&P. Additionally, **we plan to calculate a client-level transition risk score based on a set of metrics chosen for transition-sensitive sectors**.

Furthermore, as it was aforementioned in our response 10, we are also working with the other two methodological approaches for assessing and evaluating ESG risks considered by the EBA in this DP (the Risk Framework Method and the Exposure Method), jointly with the comparison of methods and their application. We broadly see the three tools can be complementary. Last but not least, **we will analyse the extent to which our balance sheet meets the EU environmental taxonomy and the GAR . In that vein, we would like to bring the EBA attention on at least these four issues**:

1) The EU taxonomy is a useful tool to mobilize and to track mobilization. At BBVA, we are early adopters. It also provides some useful information at a descriptive level for risk management.

2) So far, we have adopted a pragmatic approach for the taxonomy, and tried to strike a balance between full compliance (which would essentially mean that very few operations could be accepted), and our confidence in the underlying positive impact of the investments (for example, we have frequently relied on documents provided by the engineers involved in a building renovation to check the fulfillment of energy savings required by the taxonomy, even if these do not amount to a full energy performance certificate).

3) We are intensely using the taxonomy for our mobilization strategy. For mobilization purposes it is key that public information will be only based on the flow to be aligned with the strategy. Considering stock doesn't seem to make much sense for strategy alignment (it would imply a titanic effort and a significant amount of data wouldn't be available)

4) **For risk management purposes, we have chosen a sectoral-portfolio-client strategy instead of a product approach. Our vocation is the goals of the Paris Agreement**. While our mobilization strategy and KPIs are based on the EU Taxonomy, we have found it necessary to define some categories of sustainable investments that are not covered yet by the Taxonomy.

More details linked to the four aforementioned messages can be found in BBVA' s response to EBA Case Study as part of the CfA to the 3 ESAs related to Taxonomy Regulation Article 8.

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.

Please see our responses 10, 11 and 12.

We welcome the EBA's flexibility on the methodologies and approaches to be used over time. Quite probably methodologies applied in the bank will evolve with time, new data and investments.

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

In the case of asset managers, we consider the approaches described in the chapter are applicable for the portfolios managed by the firm. Such application, according to the relation stated in response to question 7, has an indirect impact on the risk management of the firm.

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.

Small institutions can be as vulnerable as big institutions. Then it would be useful to have a standard approach provided by regulators to account for ESG risk that could be used by those institutions with more limited resources, taking into account the **proportionality principle** for the size, the strategy and the business model.

Some empirical evidence on the risks of small institutions can be found at ECB Working Paper Series "LSIs' exposures to climate change related risks: an approach to assess physical risks" (by Maria Sole Pagliari) recently released.

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

Strengthening the sustainability approach in the definition of **sectoral policies**. Adopting **internal carbon pricing tools**, developing **scenario analysis both for transition and physical risk. Voluntary carbon markets** as a complement to the decarbonization effort. **Adequate incentives for markets** can discriminate in favour of the best ESG risk-return options.

Supervisory and central planning level measures need to be complemented with some adequate market mechanisms to speed up the transition and the development of a deep market that help to disciplinate financial and economic agents.

Portfolio management and risk planning are top-down initiatives that should be supplemented with bottom-up drivers so sustainability becomes a reality. Three useful tools are:

1) Pricing carbon emissions to properly internalize its cost through the involved players

2) Developing deep capital markets that jointly incentivize a positive discrimination for ESG emissions and transaction costs and a negative discrimination for green washing

3) Implementing fiscal policies aimed at "polluters pay and non-polluters benefit".

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

BBVA takes into account the major ESG challenges and is acting to address them. We aim at minimizing risks while maximizing any opportunities that may arise. One of our six strategic priorities is **to assist our clients in their transition to a sustainable future**. We believe that

sustainability needs to be fully integrated into business strategies and internal processes and lead by example:

The integration of ESG risk into the business strategies and processes in the BBVA Group involves three steps -identification, assessment of the impact and alignment and management- **and is based on two large blocks** -risk planning and day-to-day risk management.

Identification: deep understanding of the risks and their mechanisms (defined internally)

Assessment of the impact: BBVA is working on an internal Transition Risk Taxonomy; scenario analysis to understand their financial performance

Alignment and management: understanding which **sector**, which **client** is highly sensitive to climate risk. **BBVA manages climate risk through portfolio alignment to the Paris Agreement and engaging with clients to support their transition**.

The Risk and Compliance Committee's duties include analyzing and escalating to the Board any proposals on Group strategy, control and risk management specified, in particular, in the Risk Appetite Framework. In that vein, **the 2020 Risk Assessment has deepened the analysis**, incorporating a first qualitative assessment of the climate change factor materiality for those risks where it could be relevant (climate risk has been added to the Sectoral Frameworks).

BBVA, within the scope of preparing and defining its **industry frameworks** governing the credit admission process, has developed an internal taxonomy of transition risk in order to classify industries according to their sensitivity to transition risk. In addition, metrics are identified at the client level to assess their vulnerability and to integrate this aspect into risk and client support decisions.

The Bank is internalizing sustainability risks and opportunities, both in client transactions and in the direct impacts of its operations. BBVA initially focuses on those SDGs in which the Group can have a greater positive impact by harnessing the multiplier effect of banking with two main pillars: climate change and inclusive development.

On climate change, we are mobilizing the investments needed to manage the challenge of climate change, in alignment with three categories of business initiatives: energy efficiency, circular economy and CO2 reduction.

On inclusive development, we are mobilizing the investments needed to build inclusive infrastructures and support inclusive economic development, in alignment with digital solutions, inclusive infrastructures and support for entrepreneurs, and promotion of economic growth and full and **productive employment**.

In that vein, the Executive Committee tracks, on a regular basis, the integration of sustainability into the Group's business processes, according to its role of **monitoring and analyzing the progress of the Group's strategic key performance indicators, operations and P&L**.

More details can be found in our TCFD report here: https://shareholdersandinvestors.bbva.com/wp-content/uploads/2020/10/BBVA-report-on-TCFD_Eng.pdf

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

Please see our previous response.

BBVA's corporate governance bodies have devised and promoted a sustainability and climate change strategy for the Bank, approving its basic elements and regularly monitoring its implementation across the Group. This task is carried out by the **Board of Directors** (BBVA's highest representation, administration, management and surveillance body) with the assistance of its specialized committees. The Executive Committee and the Risk and Compliance Committee specifically play the most active role in assisting the Board on sustainability and climate change issues.

BBVA's Board of Directors has long considered the progress and main impacts of sustainable development and the fight against climate change as important matters. These have become even more important issues to monitor in recent years. The Board approved at the end of 2019 the Group's strategic plan, which defines "to help our clients transition toward a sustainable future as one of our six priorities.

An essential element is the integration of sustainability and the fight against climate change into the Group's business. **They are considered as medium and long term development opportunities** which will be managed by establishing objectives to facilitate their implementation, oversight and monitoring of progress.

In 2020, the Board approved the Group's Sustainability Policy, which defines and sets out the general principles, the main management and control objectives and guidelines to be followed by the Group on sustainable development. The Board of Directors will oversee the policy's implementation directly or through the Executive Committee, on the basis of periodic or ad-hoc reports received by the Global Sustainability Office, the Head of Corporate & Investment Banking (who is responsible for this policy at the senior management level), the Bank's areas that will incorporate sustainability into their day-to-day businesses and operations and, where appropriate, the Heads of BBVA's control functions.

As just mentioned in our response 17, the Executive Committee tracks, on a regular basis, the integration of sustainability into the Group's business processes, according to its role of monitoring and analyzing the progress of the Group's strategic key performance indicators, operations and P&L.

BBVA follows a dual bottom-up and top-down process in sustainability decision making.

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

There are significant gaps in the multiple datasets that are important for the measurement and analysis of climate-related risks. Data collection in the origination process is a necessary step to incorporate ESG risk in the risk management framework. Data collection can prove difficult for institutions with a footprint that expands outside Europe.

Data quality needs to be significantly improved to address the green finance challenge with the same rigour the other risks are dealt with, for example credit risk. Better data will help towards better risk measurement and management, and, therefore, to more efficient price formation. More efficient price formation will contribute to promote an adequate discrimination in favour of the best risk-return ESG options.

Additionally, it would be desirable to have **some common methodological standards provided by regulators and supervisors**. Harmonization between the different approaches of different international institutions would also be helpful. There have been initial steps to develop modelling approaches but this is still at an early stage of maturity and is reliant on sufficient high-quality data.

In many cases, **data sources and criteria are heterogeneous and non-comparable**. Furthermore there is some asynchronous and heterogeneity in modelling techniques. i.e.: you are given the pathway but not some needed concrete parameters to run or to calibrate the models. In a nutshell, it is currently more an art than a science.

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 agree with the "incremental approach", climate and environmental risk management are to be developed first. Governance and social risks can be particularly challenging for entities operating outside Europe, in particular in developing countries (even more than environmental risks).

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

As commented above, in the case of asset management companies, due to both, **the fiduciary responsibility and the indirect impact in the financial situation of the company**, the management of ESG factors and risk should be **focused on the managed products portfolios**. This fact implies certain **specificities** to what is commented in the text.

With regards to business strategies, including the definition and consecution of the goals, the relevance of final investors objectives, trends and behavior should be considered. Not all the products can maintain the same ESG characteristics and, regardless of the effort of the asset manager, the final allocation of investors clearly impacts the metrics upon which scores may be defined. For instance, there is a clear positive correlation between the degree of development of a country and its ESG scores. This implies that inflows in emerging market products could derive a negative impact on the metrics used. A global asset manager may have a wide range of products with different characteristics, geographical exposure among them, and may be sensitive to the allocation of the investors. Therefore, **we consider that goals on a product basis** are more manageable than goals on a company basis.

We agree with recommendations related to the business strategy on sustainable products in the asset management business, being those one of the main tools to be considered in order to enhance the ESG profile of the total portfolio. Besides, we think that the incorporation of ESG factors and risks in our investment and risk management process, **allow us to improve the risk/return profile and the quality of the products that we manage on behalf of our clients**, which in the long term will impact positively on the profile of our business.

In the case of internal control and risk management we also consider that conclusions and recommendations apply to asset management companies.

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.

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.

Yes we do. It makes sense to us.

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

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

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.

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?

Annex 1

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

We are already using a bunch of the indicators about our clients included in Annex 1:

For climate risk management: Total GHG emissions (broken down by scope 1, 2 and 3 carbon emissions); Carbon footprint, Fossil fuel sectors, Energy consumption intensity, Use of renewable sources of energy,

Please see pages 51 to 54 of our TCFD Report for more details:

https://shareholdersandinvestors.bbva.com/wp-content/uploads/2020/10/BBVA-report-on-TCFD_Eng.pdf

For biodiversity and healthy ecosystems: presence in geographic areas particularly vulnerable to biodiversity and ecosystem change', operations affecting IUCN Red List species and/or national conservation list species,

Please see mentions included in our Environmental & Social Framework:

https://shareholdersandinvestors.bbva.com/wp-content/uploads/2021/01/Environmental-and-Social-Framework-_-Dec.2020-140121.pdf

For social factors: forced labour, minimum age and child labour, discrimination and other social issues related to Human Rights.

Please see Environmental & Social Framework and BBVA and Human Rights:

https://shareholdersandinvestors.bbva.com/wp-content/uploads/2021/01/BBVA-and-Human-Rights_-2020_Eng.pdf

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.