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FBF's reply to the EBA discussion paper on management and supervision of ESG risks for credit institutions and investment firms

General considerations

The French Banking Federation (FBF) welcomes the opportunity to comment on the discussion paper issued by the EBA on management and supervision of ESG risks for credit institutions and investment firms.

We share the view that the EBA paper is comprehensive, globally well-balanced and demonstrates a good understanding of the challenges faced by credit institutions when incorporating ESG factors into risk management. As you know, credit institutions are increasingly active in the assessment of climate risk drivers which may in the medium and long term harm their clients' solvency and viability and impact their own profitability.

ESG risk drivers, including climate physical risk, are however difficult to quantify. Consequently, we are deeply convinced that in a first stage a qualitative approach should be favoured to progressively include those risks in banks' frameworks. *A phase-in approach* is highly necessary to organize internal processes and systems, retrieve appropriate data and develop robust methodologies.

Regarding the SREP notably, this progressive approach could consider the different ESG components (as banks are more mature on climate transition risks) but also portfolio segmentation, as well as different SREP elements. While the inclusion of ESG factors into the business model and governance appears sensible in the short term, it does not seem appropriate to include them into ICAAP or ILAAP.

Also, there are many initiatives covering ESG factors and ESG risk drivers. Therefore, we consider it of the outmost importance to reach a common understanding of them both. Equally, as stated in the discussion paper, ESG factors and their associated risks are likely to evolve over time. So, we share the view that any policy framework should allow enough flexibility to adequately address emerging issues in the transition to a sustainable economy. In this regard, we welcome the non-prescriptive approach of the discussion paper on methodologies and KPI: there is value in supervisory expectations providing scope for institutions to adapt their response based on their business model, size and exposure to certain risks and opportunities. Still, some clarification would be much appreciated to gain understanding of the medium-term supervisory expectations and proceed accordingly.

Regarding the **time horizon**, we suggest distinguishing between short-term (1-3 years) and medium/long term (3-10 years) risk horizons. We propose to limit the long-term horizon to 10 years, which already represents a considerable extension of the current strategic planning horizon. This time horizon is compatible too with the weighted average life of banks assets. Respective E, S and G risks may also have different time horizons.

a) In a **short-term** horizon, the focus should be on the correct **assessment of risks**. ESG factors act as risk drivers and should therefore be taken into account in the time horizon. This can be achieved qualitatively or quantitatively when accurate methodologies and data are available.

b) In a **medium/long-term** horizon (3 to 10 years), the focus should be on consistency in approaches:
   - making sure that the strategy of institutions was built considering ESG factors and expected ESG trends in a qualitative manner, and
   - monitoring of few long-term KPIs to assess the alignment with international objectives (such as the Paris agreement goals).

Scenario analyses could be a useful tool to feed thought around business strategy, but their results should be used with caution and cannot as such be used as a tool measuring properly banks' resilience, due to methodologies and data issues.

In the same vein, risk-based approach, proportionality, and materiality should be overarching principles when considering inclusion of ESG risk drivers into risk management framework and SREP. As part of the supervisory approach, there is a need to encompass different starting positions and materiality of risk drivers. Some firms will be more affected by certain risk drivers than others depending on their current exposures to climate-related financial risks, e.g., due to the geographical location of their businesses and assets, availability of insurance, their degree of adaptation as well as risk mitigation measures.

In addition, while we support the banks' efforts to proactively incorporate ESG factors into risk management, we believe that it cannot be a substitute for necessary public policy actions by way notably of incentives for economic actors to shift their economic behaviour and foster sustainable development. Banks will take their share and will complement EU's policies, but they cannot act in isolation.

We also think that a clear distinction should be drawn between acute and non-predictable events (black swan events) and long-term trends, as they have a different impact on prudential risks.

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

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

In order to identify other relevant frameworks for ESG factors beyond those mentioned in the discussion paper, we should distinguish between:

a) Frameworks and/or legal frames included as reference documents in banks' internal policies/frameworks, such as:
   - The standards for social and environmental performance and the explanatory notes of the International Finance Corporation (IFC).

- The United Nations Global Compact, the Universal Declaration of Human Rights; the International Labour Organization Declaration; the Convention on the Rights of the Child; the Rio Declaration on Environment and the United Nations Convention against corruption.
- The Task Force on Climate-related Financial Disclosures (TCFD).
- Duty of Care Law (France)
- The EU Non-Financial Reporting Directive

b) Frameworks to be considered on a case-by-case basis when necessary:
   - Sustainability Accounting Standards Board (SASB)
   - Climate Bond Initiative (CBI)
   - ICMA Social Bond Principles (SBP) and Green Bond Principles (GBP).
   - LSTA Green Loan Principles (GLP).

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

Page 26, $30: 'ESG factors are environmental, social or governance characteristics that may have a positive or negative impact on the financial performance or solvency of an entity, sovereign or individual.'

Page 28, $38: 'ESG risks mean the risks of any negative financial impact to the institution stemming from the current or prospective impacts of ESG factors on its counterparties'.

We agree with the definition of **ESG factors** and the fact that they may have positive and negative impacts, potentially acting as risk mitigators or risk drivers.

Regarding the definition of **ESG risks**, we suggest replacing "*the risks of <u>any</u> negative financial impact to the institution"* by *"the risks of a <u>material</u> negative financial impact to the institution*", to better reflect that risk management is based on materiality. What is meant by *"Prospective"* should also be further defined.

In addition, we share the view that the distinction between ESG factors and ESG risks is somewhat confusing and we would welcome some clarifications and simplifications.

If the definition of ESG factors is pretty straightforward and intuitively understandable, in the sense that those factors can trigger or aggravate the materialization of some risk types such as credit risk, market risk or operational risk, introducing the notion of ESG risks does not bring clarity. A credit risk that is triggered or aggravated by one or several ESG factors remains a credit risk. If it is important to identify situations where credit risk events are triggered or aggravated by ESG factors, their intrinsic nature does not change because they are "colored" by ESG factors.

For the EBA, ESG risks are defined as *"risks of any negative financial impact to the institution stemming, from the current or prospective impacts of ESG factors on its counterparties"*. This means that all scenarios / risk events, the driver(s) of which are ESG factors and that lead to negative financial impacts for the institution, shall be considered as ESG risks no matter their intrinsic risk type (credit, market, operational...). If the ability to identify risk events / scenarios (belonging to any risk type) that are triggered or aggravated by ESG factors is needed, creating this notion of ESG risks is not a prerequisite, nor necessary to perform such analyses.

A framework that would comprise both ESG factors and ESG risks may not be efficient. We are of the view that the concept of ESG risks does not bring value, introduces confusion, and should be banished. Instead, it should be replaced by a different wording like "risk events triggered or aggravated by ESG factors" or "risk drivers".

Furthermore, there are currently many initiatives covering ESG factors and ESG risk drivers. It is of the outmost importance to reach a common understanding of them, so that banks do not have to constantly adapt their processes and reportings. In this respect, we do support the EBA approach to treat physical risks and transition risks as transmission channels of climate-related risks.

Equally, as stated in the discussion paper, ESG factors and their associated risks are likely to evolve over time. Therefore, any policy framework should allow enough flexibility to adequately address emerging issues in the transition to a more sustainable economy.

Regarding the *double materiality concept* ($36), we believe that it should benefit from further alignment with other initiatives and be supported by additional guidance. It might be useful to illustrate the environmental materiality with some examples of indicators or measures to better understand how to assess any potential negative financial impact.

Currently, the high degree of flexibility to determine materiality makes it difficult to compare materiality assessments and the content of reports. Therefore, we suggest introducing a principle-based concept about how to conduct a materiality assessment.

In addition, the double materiality is difficult to manage for environmental risks but also social risks, especially when considering the full value chain in a company's production cycle. Banks can only rely on public information (be it disclosures by the companies, external tracking services – e.g. RepRisk, rating agencies), but even then, sources of information may be scarce.

Regarding the **time horizon**, we suggest distinguishing between short-term (1-3 years) and medium/long term (3-10 years) risk horizons. We propose to limit the long-term horizon to 10 years, which already represents a considerable extension of the current strategic planning horizon. This time horizon is compatible too with the weighted average life of banks assets. Respective E, S and G risks may also have different time horizons.

a) In a **short-term** horizon, the focus should be on the correct **assessment of risks**. ESG factors act as risk drivers and should therefore be taken into account in the time horizon. This can be achieved qualitatively or quantitatively when accurate methodologies are available.

b) In a **medium/long-term** horizon (3 to 10 years), the focus should be on consistency in approaches:
    - making sure that the strategy of institutions was built considering ESG factors and expected ESG trends in a qualitative manner, and
    - monitoring of few long-term KPIs to assess the alignment with international objectives (such as the Paris agreement goals).

Scenario analyses could be a useful tool to feed thought around business strategy, but their results should be used with caution and cannot as such be used as a tool measuring properly banks' resilience, due to methodologies and data issues.

We are also concerned that credit institutions may be held accountable for social and governance risks with regard to the full value chain in a company's production cycle. Consequently, we think that the scope of counterparties' transmission channels that banks may acknowledge and manage should be limited. Otherwise, considering the inclusion of all potential ESG-related transmission

channels across the value chain of banks' counterparties may lead to disincentive banks from supporting transitioning sectors/firms.

In addition, when moving forward to a more sustainable economy, the integration of ESG factors should be done in a holistic way to avoid, for instance, the improvement of an environmental factor to the detriment of a social factor. This holistic approach will also have to be tailored to different types of jurisdictions. Emerging countries will face significant social and governance risks as sustainability is yet not fully integrated into their objectives. In this regard, banks with an international footprint will be especially concerned since they will be sensitive to the idiosyncrasy of the places where they operate.

Question 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 think that ESG is above all a business development strategy. It does not solely represent potential negative impacts over banks' counterparties but should be primarily considered as the key vector for business development in the coming years. Therefore, from a prudential perspective, supervisors' practices should consider positive effects and incentives as well.

When comparing individual companies in individual sectors, a positive assessment of the company's management of its ESG factors will have a positive impact on its ESG profile and should therefore be considered ("best in class" per sector for instance).

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

Page 33, $54: Physical transmission channels/physical risks are the risks posed by the exposure of institutions to counterparties that may potentially be negatively affected by the physical effects of climate change or other environmental factors, including:

> ***a. acute physical effects, which arise from particular events, especially weather-related events such as storms, floods, fires or heatwaves, that may damage production facilities and disrupt value chains; and***
>
> ***b. chronic physical effects, which arise from longer-term trends, such as temperature changes, rising sea levels, reduced water availability, biodiversity loss and changes in land and soil productivity.***

We believe that the proposed description of physical risks provides a very welcome clarification to the fact that "*environmental events other than climate change can drive physical risk*".

Some definitions provide specific examples, while in other cases more general examples are provided. Therefore, we suggest taking out the sentence *"that may damage production facilities and disrupt value chains"* as the discussion paper had until now refrained from including examples in the definitions. Otherwise, we agree with the proposed definition.

Page 37, $68: Transition transmission channels/transition risks are the risks posed by the exposure of institutions to counterparties that may potentially be negatively affected by the transition to a low-carbon, climate-resilient or environmentally sustainable economy, including:

- ***climate and environment related policy changes, for example as a result of energy efficiency requirements, carbon-pricing mechanisms that increase the price of fossil fuels, or policies to encourage sustainable use of environmental resources;***
- ***technological changes, for example if a technology with a less damaging impact on the climate or the environment replaces a technology that is more damaging, hence making it obsolete;***
- ***behavioural changes, for example if the choices of consumers and investors shift towards products and services that are more sustainable; or if difficulties to attract and retain customers, employees, business partners and investors arise when a counterparty has reputation for damaging the climate and the environment.***

Regarding transition risks, as highlighted in relation to physical risks, in order to ensure consistency across definitions throughout the discussion paper, we suggest avoiding the inclusion of examples within the definitions. The process established throughout the document together with the substantial literature on both physical and transitions risks would favour a "less is more" approach to the definitions.

Question 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?

Page 44, $79: "Social risks are the risks posed by the exposure of institutions to counterparties that may potentially be negatively affected by social factors."

Page 45, $85: "Governance risks are the risks posed by the exposure of institutions to counterparties that may potentially be negatively affected by governance factors".

Banks are currently developing their understanding on assessing and addressing climate risks, especially transition risks, whereas other risks such as biodiversity and other environmental risks do not benefit from a similar level of understanding and offer an even more limited availability of relevant data. It is even more true for social risks ang governance risks. We reiterate our position that in a first stage a qualitative approach should be favoured to progressively include ESG risk drivers into banks' frameworks. *A phase-in approach* is highly necessary to get a better understanding of risks at stake, organize internal processes and systems, retrieve appropriate data and develop robust methodologies.

Regarding the COVID 19 crisis, its interaction with ESG risks is not straightforward. We find it is too early yet to elaborate on the potential impact of the ongoing COVID crisis on our approach to ESG factors and ESG risk drivers.

Question 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.

Page 47, $90: "Liability transmission channels/liability risks are the risks posed by the exposure of institutions to counterparties that may potentially be held accountable for the negatively impact through their activities on the environment, the society and their governance factors."

Liability risks are risk drivers which may derive from ESG factors. However, we share the view that liability risks are not limited to ESG factors and may also derive from other factors.

Question 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.

Based on the "same activity, same risks, same rules" principle, we do expect a level playing field between competitors.

We would like to highlight that specificities might need to be taken into account when it comes to risk management recommendations. However, these specificities do not stem from the nature of the entities (ie. investment firms) but rather from the activity that they are doing and that can also be found in credit institutions (investment services**). Any regulation should focus on the service provided rather than the legal form of the service provider**. Indeed, when a credit institution and an investment firm both offer investment services, a regulation based on the service provided will put the two entities on a level playing field. Any other regulatory arrangements would create an unlevel playing field and operational challenges that we need to avoid.

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

Question 12 (p53): Do you agree with the sequential steps identified in this discussion paper for the incorporation of ESG risks in institutions 'management practices? If not, explain why?

We do agree with the three-step approach (identification, evaluation, action) described into the discussion paper for the incorporation of ESG risk drivers in banks 'management practices.

However, it is a process that requires flexibility and should be driven by banks, based on their risk profile and the general knowledge of ESG risk drivers. Besides, current methodologies or available data are not accurate enough to be used as reliable tools for management decisions. Given the uncertainty level, they can only give estimations and trends.

Question 8: Please provide your views on the relevance and use of qualitative and quantitative indicators related to the identification of ESG risks.

Regarding the identification of ESG risk drivers, the use of existing qualitative and quantitative indicators (including taxonomies, standards, labels and benchmarks) will help classify exposures, particularly in relation to climate-related risk drivers for which there is more maturity on methodologies and data across the industry. However, the primary purpose of this classification exercise should be disclosure and not risk management. As far as risk management is concerned, each bank should be allowed to define its own indicators.

Question 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.

We confirm that banks use some ESG indicators for risk management purposes. They may not be the same though as for disclosure purposes.

Question 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.

For the time being, the portfolio alignment method will only allow to assess climate-transition risks and cannot be used for other ESG risk drivers. As already outlined above, priorities must be made among ESG risk drivers as the level of maturity in terms of methodologies and data is not the same for climate-related risk drivers and other ESG risk drivers.

Question 11: As an institution, do you use or plan to use a risk framework method (including climate stress testing and climate sensitivity analyses) in your approach to measuring and managing ESG risks? Please explain why and provide details on the methodology used.

Regarding scenario analyses, we would like to insist on the fact that no agreed methodology exists so far and that the primary focus is currently on climate transition risks with little progress on climate physical risk scenarios and none in relation to other environmental risk drivers.

French banks are today actively participating to the exploratory pilot exercises lead by several European and national authorities. These exercises, which are based on different approaches, are conducted on a "test and learn" mode and are not aimed yet at developing a prudential approach**.** The results of scenario analyses should be considered with great caution and the preliminary findings should not give rise to formal expectations at this stage.

We agree on EBA statement ($120) *"In contrast to the alignment method discussed in the previous section, the risk framework method focuses on the sensitivity of portfolios and the impact climate change has on exposures' actual riskiness. It does not make any statements on how the portfolio composition positions relative to global climate targets and as such does not provide an explicit guide to banks on how they would have to shift their portfolios to align. Rather, it is a purely risk driven approach. Managerial actions would reflect the level of measured sensitivity or direct risks of losses considering the current level of environmental factors (or climate more specifically) and the possible developments under the selected scenarios. It is about resilience, rather than explicit alignment – both of which in the long run in theory should lead to the same results in terms of how aligned portfolios are with global policy targets, but in the short-run arguably may not due to the well-known timing issue: some of the risks may only materialize in the long-run and accordingly can potentially slow down financial institutions' actions."*

However, when it comes to definitions, EBA's proposal could be misleading.

EBA defines climate stress tests as *"assessment featuring fully fledged scenarios that map out possible future development paths of transition variables (e.g. carbon prices), physical variables (temperature increases) and the related changes in macro variables (e.g. output in different sectors, GDP, unemployment) and financial variables (e.g. interest rates). These scenarios are then translated into changes in portfolios' (risk) attributes"* ($122). The EBA also specifies that *"stress testing can take place at portfolio, industry or counterparty level and can be conducted by national competent authorities, banks themselves or external providers. In most cases, stress tests to-date are run in the form of pilot exercises, since experience is lacking and the design of climate stress tests is very complex, facing several issues"* ($123). Notably, the EBA gives as an example the DNB "Stress test on Energy Transition Risk for the Financial System", the ACPR "Pilot Exercise on Climate-related Risks" and the BoE "Biennial Exploratory Scenario on the Financial Risks from Climate Change".

We fully agree on EBA's analyses that *"climate stress tests remain work in progress and should not be expected to provide the same level of precision as standard bank stress tests. To-date they remain of less comprehensive nature than the usual stress tests – they are an assessment of certain portfolios but do not make any conclusions about potential capital implications. Climate stress tests*

based on scenario analyses are a useful and important tool, however given their complexities and many uncertainties, they also need to be assessed and interpreted with caution." ($124)

That's why we believe that, for the moment, the "climate stress tests" wording should be excluded from the ESG risk management framework. We recommend, for the sake of clarity, that supervisors' lead pilot exercises should be called **"climate-related scenario analysis exercises"**. This would prevent any confusion with the existing EBA stress tests (next in 2023) and make it clear that climate-related scenarios should not be included in the current capital stress tests nor lead to capital add-ons through Pillar 2.

Regarding climate-related scenario analyses, banks consider them as the most appropriate tool to assess the materiality of ESG risk drivers and their impacts on business models. They welcome the pilot exercises launched by supervisors such as ACPR's pilot exercise on the assessment of climate-related risks. Thanks to fruitful experience and lessons learnt, such exercises pave the way, on both supervisors and banks' sides, for the development of reliable and robust regulatory and internal methodologies for climate-related scenario analyses. Forward-looking analyses are naturally the best approach for capturing potential impacts of ESG risk drivers, because ESG risk drivers are intrinsically forward-looking. Moreover, climate-related scenario analysis outcomes should for the time being focus on ESG-related KPIs, and in a secondary manner, specific financial indicators, in order to focus on the assessment of ESG risk drivers on the business model. **Consequently, such climate-related scenario analyses should remain clearly differentiated from solvency-related stress testing exercises, that use different methodologies, pursue different objectives and therefore measure different impacts, based on different indicators.**

Question 13 (p71): 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.

Exposure methods are useful to gain insight on the ESG profile of clients. It could be envisaged at an individual client level and not just a portfolio one.

However, such methods should be sequenced and tailored internally by each bank, based on its business mix. Also, only corporate clients should be in scope, as data availability may largely differ from one client segment to another. In addition, given the high level of uncertainty, such methods cannot be used on a stand-alone basis and should be completed with a qualitative approach.

Question 13 (p77): 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.

Some banks may envision to use different approaches in addition, based on their business models.

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

Methodological approaches should be not be tailored to the nature of the entities but rather to their activities, as the same activities convey the same risks.

Chapter 6: The management of ESG risks by institutions

Question 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.

We do not agree that smaller institutions are per se more vulnerable to ESG risk drivers than larger ones. Vulnerability will be more directly linked to a bank's business model, its sectorial exposures and its level of risk concentration.

Whereas we favour the introduction of **proportionality** to ESG factors in the risk management, we do not think that size should be the core driver to a proportionate approach. Instead, the materiality of ESG risk drivers should be the main point of focus.

Depending on the institution's business model, some ESG risk drivers may be more relevant than others. The proportionality principle should then apply, with the institution developing full internal methodologies for the most relevant risks and simplified ones for less relevant risks, at least in the short term.

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

A better availability and reliability of underlying data would help further support the adoption of ESG risk-related objectives and/or limits.

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

Engagement with customers and other relevant stakeholders

While we support engagement with clients on ESG risks assessments, we share the view that banks should have flexibility in implementing such a dialogue. Notably, banks should be able to define their top priorities, based on their business model, on a best effort basis (focus on customers in sectors that will be most challenged by ESG factors), as an application of the proportionality and materiality approach.

Development of sustainable products

We do not think that "sustainable" labelled products are necessarily more resilient to ESG risk drivers. Even a portfolio that is 100% green may be risky as it may be subject to transition risk. Battery-powered vehicles, for instance, may become obsolete if in the future hydrogen cars turn out to be the best mobility alternative.

In this regard, we would like to reiterate that the EU taxonomy is not aimed at risk management, even though the expectation is that steering towards sustainable product offering will help de-risk portfolios. Indeed, there are many other factors that may unfavourably impact a bank's counterparty, apart from ESG factors.

Time horizon

As already stated, the time horizon for ESG risk drivers is significantly longer than the average time horizon for strategic planning. Due to the lack of reliable data, it might prove challenging to

integrate long-term effects of ESG risk drivers into business strategies. We would welcome a clarification that a full-fledge financial planning on longer time horizons is not expected.

Instead, making sure that the banks' strategy is built considering ESG factors and ESG trends in a qualitative manner and that there is a monitoring of a few long-term KPIs to measure alignment with international objectives (such as the Paris agreement goals), looks a better fitted approach. Scenario analyses could be useful tools to feed thought around business strategy, but their results should be interpreted with caution and cannot be used to measure properly banks' resilience, as they are not the right tool. In this regard, portfolio alignment methods (such as the PACTA or internal methodologies inter alia) seem more appropriate.

CRD/CRR

The discussion paper (page 94) recommends incorporating ESG factor-related considerations into directives and regulations applicable to the banking sector (e.g. CRD and CRR). We think that it is too early to put this topic forward. We suggest that the EBA completes first its preliminary studies.

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

We welcome the policy recommendation (page 100, b) to incorporate ESG risk drivers into existing committees or committees to be created, at different levels and proportionate to the size, complexity, and business model of the banks. Flexibility in this matter is very central.

Regarding the allocation of the responsibility related to ESG risk drivers to a member of the management body (page 100 – recommendation d), we think that this is not appropriate as the management body (board of directors) is a unique and inseparable body with collective responsibility, through which both management and supervisory functions are performed. Therefore, such responsibility is shared by "the management body" itself and not a specific member. We suggest deleting this recommendation. Also, the EBA should clarify that, in the discussion paper, when a reference is made to the "management body" of an institution, it should be understood as the management body in its executive capacity.

Page 101, the discussion paper recommends (recommendation k), for banks that have set ESG risks-related objectives, to consider implementing a remuneration policy that links the variable remuneration to the successful achievement of these objectives, while ensuring that green-washing and excessive risk-taking practices are avoided. We think that the scope of this recommendation should be restricted to senior management individuals who are responsible for the definition and the implementation of the bank's strategy on such matters. Additional requirements in the remuneration policies of the staff will depend on the mission/function on the employee: there is a need for flexibility for each bank to amend its remuneration policy accordingly. Such a topic should hence not be decided through regulatory measures.

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

In some areas, ESG risk drivers are in the process of being integrated into the risk management of many credit institutions but there are still many challenges to overcome that will take time to address. Methodologies are still work in progress and there is a lack of available and reliable data.

Taking into account the long-term time horizon in which ESG risk drivers could materialize is another challenge.

Finally, the discussion paper states that *"institutions should be able to generate aggregated data efficiently on a timely basis to meet a broad range of on-demand request"* (page 114). We would like to point out that, for banks to be able to generate such reports, a common framework will have to be stabilized first, which may require some time. Besides, current external data should prove to be reliable enough to be used in risk management frameworks: the data providers must be regulated and audited by external bodies to assess the data quality.

Question 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 share the view that the understanding of environmental risk drivers, and more particularly climate-related risks, is more advanced, compared to social and governance risk drivers. Consequently, it is of the outmost importance to address ESG risk drivers in a phase-in perspective, based on the maturity of the topic and notably the availability and reliability of data.

Question 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 already stated, based on the "same activity, same risks, same rules" principle, we do expect a level playing field between competitors.

<u>Chapter 7 : ESG factors and ESG risks in supervision</u>

Question 22: Please provide your views on the incorporation of ESG factors and ESG risks considerations in the business model analyses of credit institutions.

We do agree with the incorporation of ESG factors and ESG risk drivers to the business model analyses of credit institutions. NB: we prefer not to use the wording "ESG risks" (see our answer to Q2).

Indeed, as already stated (Q3), banks consider that ESG is above all a business development strategy, which means that it does not solely represent potential negative impacts over banks' solvency but should be considered primarily as the key vector for business development in the coming years. Consequently, the first step would be to connect ESG to the Business Model Analyses part of the ICAAP. A strong business model analysis enables informed strategic decision-making, supports the transition to a more green and sustainable business model, and therefore strongly mitigates risks potentially impacted by ESG risk drivers, such as business and strategic risks. We also appreciate the proportionality approach put forward in the discussion paper and we would like to reiterate the fact that size is only one component of it (see our answer to Q15).

Regarding environmental factors, the supervisor should consider that methodologies are still at an early stage and that available and reliable data will be a prerequisite. In this regard, the introduction of social and governance factors will be even more challenging, as maturity on these topics is even less developed.

Question 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 analyses the assessment of the long term resilience of credit institutions in accordance with relevant public policies? Please explain why.

Conceptually, we do understand that the time horizon of the supervisory assessment of ESG factors and ESG risk drivers should be extended. However, from a practical point of view, a longer time horizon would create many challenges.

Indeed, an assessment based on an extended time horizon would present a great amount of uncertainty and the reliability of the results might be questionable. The main hurdles would be the access to adequate historical data and the lack of convergence of methodologies. We would welcome a clarification that a full-fledge financial planning on longer time horizons is not expected. This would not be appropriate, considering the high level of uncertainty of the outcomes.

Instead, making sure that the banks' strategy was built considering ESG factors and expected ESG trends in a qualitative manner and that there is a monitoring of a few long-term KPIs to measure alignment with international objectives (such as the Paris agreement goals), looks a better fitted approach. Scenario analyses could be useful tools to feed thought around business strategy, but their results should be interpreted with caution and cannot be used to measure properly banks' resilience, as they are not the right tool. In this regard, portfolio alignment methods (such as the PACTA or internal methodologies inter alia) seem more appropriate.

Question 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.

In our view, the incorporation of ESG factors and ESG risk drivers into the assessment of a bank's internal governance and wide controls has to be carried out following an homogenous approach compliant with existing standards and guidelines and be incorporated into governance arrangements in a proportionate and progressive way, taking into account their impacts from a prudential point of view.

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

Regarding the integration of ESG climate-related and environmental risk drivers into the prudential supervisory framework and the SREP, we would like to stress that ICAAP is an internal process fully owned and managed under the banks' responsibility, as stated by the ECB in its ICAAP Guide. Therefore, methods for integrating ESG climate-related and environmental risk drivers should be defined and implemented by banks as deemed adequate for internal economic risks monitoring and decision-making purposes. ICAAP is a complex process that links several strategic decision-making and risk management processes, articulated with a comprehensive internal economic perspective, a normative regulatory standpoint, and a forward-looking dimension, altogether enabling banks to demonstrate their present and future capital adequacy.

Banks generally agree with NGFS and EBA findings that integrating ESG climate-related and environmental risk drivers into the prudential supervision framework remains very challenging as:

- ESG covers a wide range of concepts, some of them still being under development.
- Understanding and awareness of ESG still requires a huge mobilisation to achieve the defined goals.

- From a practical point of view, despite all the progress and achievements realised in the recent years, there is still a lot of work to be done to build a common understanding and definition of ESG.

Consequently, the optimal prerequisites for a consistent integration of ESG into the current prudential supervisory framework are not met yet.

Beyond such general considerations, banks generally agree with NGFS findings that, within the regulatory perspective of the ICAAP, the Basel capital framework is not adapted to a relevant integration of ESG climate-related and environmental risk drivers:

- The Basel capital framework largely relies on backward data that are in particular used to quantify the regulatory capital requirements for credit risk and operational risk (the most impacted prudential risk types). This is contradictory with the intrinsic forward-looking nature of ESG risk drivers.
- Moreover, the Basel capital framework is intended to cover a specific amount of potential loss at a 1-year horizon. This is again contradictory with the intrinsic long-term nature of ESG risk drivers.

Consequently, banks underline the risk of unexpected adverse second round effects resulting from an inadequate or inconsistent integration of ESG risk drivers into the Basel capital framework, leading to unjustified increases in regulatory capital requirements, and finally hampering banks capabilities to contribute to the fight against climate change and environmental damage.

After a very preliminary analysis, we think that other ICAAP components are more adapted to a careful integration of ESG climate-related and environmental risk drivers into the prudential framework supervision.

Regarding the business model analysis, please refer to Q 22.

Another interesting path for connecting ESG and ICAAP is the Risk Identification Process. As of today, banks already integrate ESG risk drivers into some of the risk events of their Risk Inventory that ultimately enable them to identify their material risks. This setup paves the way for capturing ESG risk drivers' impacts into the calculation of the internal capital requirement for material risks. By doing so, climate and environmental risk drivers are reflected into the calibration of the internal risk models through their impacts on the frequency, severity and dependency of risk events. They hence already contribute to the establishment of capital needs under the internal perspective, and this contribution will increase as their materiality grows in the medium term.

At this stage, it may be helpful to specify that banks allocate internal capital to defined material risk categories. However, they do not allocate individually capital to risk drivers, which contribute, at an earlier stage of the risk identification methodology, to the risk's materiality assessments.

Regarding climate-related scenario analyses, banks consider them as the most appropriate tool to measure the materiality of ESG risk drivers and their impacts on the business model and welcome the participation to pilot exercises such as ACPR's pilot exercise on assessment of climate-related risks. Thanks to fruitful experience and lessons learnt, such exercises pave the way, on both supervisors and institutions' sides, for the development of reliable and robust regulatory and internal methodologies for climate-related scenario analyses. Banks have chosen to focus on climate-related analyses because forward-looking analyses are naturally the best approach for capturing potential impacts of ESG risk drivers, as ESG risk drivers are intrinsically forward-looking. Moreover, climate-related scenario analysis outcomes should for the time being focus on ESG-related KPIs, and in a secondary manner, specific financial indicators, in order to focus on the measurement of ESG risk drivers on the business model.

Consequently, such climate-related scenario analyses should remain clearly differentiated from solvency-related stress testing exercises, that use different methodologies, pursue different objectives, and therefore measure different impacts, based on different indicators. This necessary separation between these two different exercises does not prevent integrating them into the ICAAP, with Business Model Analyses as a cornerstone. Indeed, the ICAAP seems as of today an adapted mean to support strategic decision-making and provide consistent and comprehensive reporting about ESG risk drivers to both banks' management bodies and supervisors.

Regarding the assessment of risks to liquidity and funding, the link with ESG factors and their impacts is not appropriate. Since ESG risk drivers are expected to materialize over a long-term time horizon, they do not have any meaningful impact on the liquidity of banks in the short term.

Question 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.

We strongly support the principle of proportionality elaborated on in the discussion paper. We would like to emphasize that size is only one component of it: assuming that larger or smaller banks are vulnerable to ESG factors simply because of their size is not accurate. The business model of an institution, its internal governance, the nature and complexity of its activities and their location are also crucial.

Question 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?

We consider that chapter 7 of the discussion paper does cover all the relevant channels through which ESG factors should be incorporated in the supervisory review of credit institutions.

<u>Annex 1</u>

Question 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 acknowledge the fact that the list of indicators and metrics provided in the discussion paper is a non-exhaustive one. In this regard, it could be usefully supplemented, notably regarding social and governance factors.

Some of the listed indicators may be a starting point to gather information from banks' counterparties on ESG matters. They may also be used in the development of product offerings. Some banks have taken them into consideration as part of a product taxonomy development (separate from a risk taxonomy of sectors). **However, most of these indicators are not suitable for risk management purposes and would be difficult to use outside the EU.**

Question 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.

The main obstacle about the non-exhaustive list of ESG indicators and metrics provided in the discussion paper relates to the availability and reliability of data, which is globally a major pervasive

challenge for ESG. Besides, data providers must be regulated and audited by external bodies to assess the data quality.

In addition, some of the indicators (such as the carbon footprint for instance) are calculated by the banks' counterparties themselves. Therefore, they may not always be available, notably for SMEs.