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EACB comments on EBA Discussion Paper On management and supervision of ESG risks for credit institutions and investment firms (EBA/DP/2020/03)

General comments

The EACB welcomes the opportunity to comment on the draft EBA Discussion Paper on management and supervision of ESG risks for credit institutions and investment firms.

We appreciate the comprehensive approach pursued by the EBA, with a view to have a consistent integration of ESG risks in the prudential domain building upon established concepts such as risks to capital and liquidity and the overall governance framework.

We believe that indeed ESG risks can only be integrated in the SREP by reflecting them in the existing four SREP components, or pillars, (from business model and governance to risks to capital and liquidity coming from the known categories of credit, market and operational risk).

Incorporation of ESG factors into governance arrangements of the institutions. With regard to governance arrangements and the allocation responsibilities for ESG risks at the level of the management body, we would suggest that the discussion paper and any future EBA GL clarifies in an unambiguous manner that such allocation of tasks/responsibilities does not imply an individual legal liability of a member of the management body, which would be against the national legislation (principle of collegiality) in some Member States. In addition, some recommendations should be considered relevant only at a consolidated level in a cooperative group; a range of solutions should remain possible while keeping in mind that the objective is an integration of ESG in governance that is effective and adequate.

It is also essential to ensure that future EBA expectations or regulatory products are consistent with the already existing framework and do not contradict/overlap existing legislation and guidelines (e.g. the GL on suitability assessment, aka “fit & proper”). It is crucial to ensure legal certainty and clarity to all market players, and any inconsistences or prescriptive guidance without a legal basis should be avoided. We encourage the EBA to work in close coordination with the European Commission given the existing elements on sustainable governance present in the Commission’s work programme.

Social (S) and governance (G) aspects

It is clear that for the time being the emphasis will be on environmental aspects (E), while time will be needed to reach well rounded approaches on social (S) and governance (G) aspects. We would encourage EBA to allow banks the time to develop expertise on the E before rushing into the development of requirements also on the S and G. Certainly, differences in governance structures have to be properly reflected, especially with regard to the cooperative banking model.

Engaging with customers and other relevant stakeholders

At the same time, we call on policy makers not to shift entirely on banks the burden to stimulate an orderly transition of economic agents. While customers’ engagement is primal, and cooperative banks are by their very nature committed to accompany their members/customers on a long-term relationship, this engagement to support transition has its limits. Banks might be able to encourage customers, but not oblige them. We also see that customers’ activities are indeed the source of ESG risks – as it is the nature of the exposure to ESG

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factors that will impact the financial situation of banks – but proactive engagement is only possible up to a certain extent, and certainly not beyond the level allowed by the customer. Moreover, it should be taken into account that the Covid-19 crisis requires the full attention of the banks to support their clients. Any soft regulation should not imply changes in the banks IT systems.

Furthermore, the engagement with customers by banks with a view to pursue public policies' objectives should not be expected to be higher than the engagement of public authorities themselves. That is, the required information on sustainability for a bank in order to approve a loan should not be more demanding than that required by public authorities in order to provide a grant, a tax deduction, etc.

Finally, we would like to highlight that cooperative banks have a longstanding orientation towards close and long-term engagement with customers. Client/members are the owners of the banks, they may sit in the management body, and cooperative banks play a fundamental role in animating and serving the economic and social life of the local communities. Moreover, they generally pursue a very conservative attitude regarding the distribution of profits and the enhancement of the capital position. These features should be adequately considered as "natural" risk mitigants in particular when supervisors come to assess the social and governance factors and risks affecting institutions.

Answers to specific questions

Q1: Please provide details of other relevant frameworks for ESG factors you use.

xxx

Q2: Please provide your views on the proposed definition of ESG factors and ESG risks.

We support an approach distinguishing between ESG factors and ESG risks, where the factors translate into financial risks and by this way impact institutions and the financial system. Indeed ESG factors would manifest themselves in financial or non-financial prudential risks, such as credit, market, operational, liquidity and funding risks. We note that the EBA indicates (para. 34) that "*while ESG factors can have positive or negative impacts, the ESG risks for the purpose of this discussion paper are defined from a prudential perspective, in the context of the supervisory review, as the negative materialisation of ESG factors.*" This focus on the downside should not overlook the fact that positive materialization of ESG factors could also play a role from a risk assessment perspective, just like any form of risk diversification. Moreover, examples of the factors should be incorporated into the definition.

While banks certainly have to become aware of many ESG risk factors and learn to understand their relevance, it should be noted that banks naturally tend to understand and manage new risks that emerge, this can be the case for instance of outdating of technologies and of products, the change of consumer preferences, etc. Such challenges are relevant also outside of the ESG dimension and possibly even to a higher degree (e.g. due to digitalization, change of public opinion, etc.) and institutions may put in place risk mitigation strategies which should be taken in due account by supervisors.

With reference to the definitions of ESG risks we reiterate once more the importance of a consistent and coordinate approach across regulatory and supervisory products. We appreciate that the EBA makes a first attempt in the DP for broad and common definition for ESG risks that can be applied to all existing and coming requirements. Harmonized definitions would enable a uniform and comparable understanding of ESG factors and ESG risks by the respective actors. This is clearly a demanding task as definitions have to be in line with the Taxonomy Regulation, the Disclosure Regulation, the approach outlined in the ECB Guide on climate-related and environmental risks, and also the own EBA GL on Loan origination, and so on.

We note for instance that the definition in the discussion paper is slightly different from the one in the Disclosure Regulation. While the DP indicates "*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*" the Disclosure Regulation (Regulation 2019/2088 EU) refers to 'sustainability risk' as "*an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment*".

On the one hand, the Disclosure Regulation places emphasis on the "material negative impact", on the other hand the DP includes "any negative financial impact" in the definition. We agree instead that "*a risk-based approach that takes into account the likelihood and the severity of the materialisation of ESG risks should be followed.*" (para. 98) We would also expect the materiality of the financial impact to be relevant for proportionality of the analysis.

Moreover, while the Disclosure Regulation takes the individual investment perspective, the Discussion Paper focuses on the counterpart as a whole.

We would also reiterate the need for the use of consistent terminology across the framework, by EBA and the Commission for instance. Consistent terminology and clarity of the general framework are essential to being able to use the taxonomy in a manner that can serve also the supervisory processes.

Regarding the expectation to include sovereigns and individuals as counterparties on the ESG risks' assessment, more clarity is necessary. The consultation document states: "*Individuals, for example, when they are employed by a carbon-intensive company that fails due to new carbon pricing mechanisms, and sovereigns, for example, when the transition causes mass unemployment and therefore a deterioration of tax income or increased public spending*". We believe that ratings of sovereigns provided by credit agencies under a holistic and multifaceted approach would already include these aspects. However, for the sake of clarity a differentiation would be needed between central and local government for instance. While information on central governments is usually more transparent and readily available the same cannot be said for the decentralized governmental entities. Regarding individuals, the question would be whether banks have to consider jobs as part of the scoring and expected default calculations (the lack of reliable data is an evident issue on this matter. There is very little information out there on how to evaluate sovereigns and it would seem reasonable to exclude them from the analysis at this stage.

Finally, a differentiation is needed in the definition framework between directly and indirectly driven risks in order to distinguish clearly in the banking and supervisory processes between those two views. This should also be considered in the context of tools, rules, processes, materiality, governance etc.

Q3: 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.

ESG factors have on the one hand negative implications, but on the other they also create opportunities for business enterprises. In this respect both elements are relevant.

In a first stage, banks should possibly focus on the negative impacts in order to become aware of the inherent risk potential of the relevant counterparties. However, this may only provide a rough picture.

When it comes to map the (successful) transition of a company towards a positive ESG rating, however, the angle of negative impacts might not provide sufficient information. In the same vein it might be difficult to properly assess companies/groups carrying out different activities, when only one angle is primarily reflected.

We also would like to emphasize that, according to the EBA's definition, in case of a short position on a counterparty, the negative financial impact on the credit institution will materialize when the counterparty performs better.

Q4: Please provide your views on the proposed definitions of transition risks and physical risks included in section 4.3.

When talking about the combination of physical risk and transition risk, we see that each sector and company is mostly affected by one risk or the other. Physical risk seems to affect especially companies and sectors with greater relationship with natural resources (land, water and ecosystems) or with the main business linked to buildings and their geographical placement. Emissions intensive sectors seem more affected by transition risk linked to climate change and circular economy (waste efficiency). Every one of these risks, physical and transitions risk should be considered when they are material for a sector; in some cases both will have to be considered.

Q5: Please provide you views on the proposed definition of social risks and governance risks. As an institution, to which extent is the on-going COVID-19 crisis having an impact on your approach to ESG factors and ESG risks?

The DP already mentions the social and governance risks perspective, as per the mandate given in CRD. At this stage, the ECB is instead focusing is supervisory expectations on climate related risks (in the ECB Guide on climate-related and environmental risks). We understand that the aim of EBA is to launch a first reflection on the S and G components, however it remains unclear to what extent these risk components can be adequately captured for the time being.

The definition of social and governance risks is rather high level, but appropriate in light of the above elements. On the other hand, linking social risks with environmental risk seems somewhat forced. Certainly, there are interfaces between social risks and environmental risks, however we do not believe it is necessary to highlight these boundary risks separately, particularly to this extent. Also considering that this does not adequately reflect the interconnections within the social risks.

A key aspect to frame is whether these elements should be assessed at macro level or adjusted to the counterpart. We believe that at least in a first stage a macro analysis would be more suitable, also with a view to develop first tools and indicators.

Furthermore, it is important that governance risk considerations are seen in context with the current Commission consultation on sustainable corporate governance, and that the potential outcome from that workstream is taken into account, as it may also lead to reconsider a number of governance aspects from a wider angle. It is essential that supervisory expectations and general policy do not send contrasting signals nor impose a layering of requirements that becomes difficult to translate in practice and manage. Moreover, a unified and standardised approach towards the financial materiality of social and governance factors would be a necessary reference.

In this context, we would also stress that cooperative banks have particular governance features, which need to be reflected in the context of S and G factors. It is the purpose of the bank to promote the economic interest of its members. Client/members are the owners of the banks and may sit in the management body. This usually implies a longstanding orientation towards close and long-term engagement with customers. Due also to the legal and statutory features, cooperative shares are not steered with a short-term income maximization perspective, but rather with a view to ensure steady and sound profit generation and to continuously enhance the capital position. The major part of the profits is usually introduced into the reserves.

In this vein, cooperative banks play a fundamental role in animating and serving the economic and social life of the local communities and ensuring social cohesion, also in areas that would otherwise be unbanked. These features should be adequately considered as "natural" risk mitigants when supervisors come to assess the social and governance factors and risks affecting institutions.

Q6: 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.

The description of the transfer of liability / liability risks including the consideration that liability risks can also arise from social and governance factors is understandable. However, liability risks should not just be related to ESG risks. Since they are generally part of the business environment, a separate consideration in the ESG context does not seem necessary and is also inconsistent with the risk maps / definitions of many institutions. In particular, it is difficult to foresee legal costs that could arise due to possible future changes in behaviors. In our view, fears about the threat to financial stability also go too far. Liability risks are generally already taken into account in the context of operational risk.

Q7: 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.

Generally, we do not think that in terms of definitions, a difference is to be made between credit institutions and investment firms. Everyone should be able to use the same definitions of ESG risks for more regulatory certainty. It would also avoid any risk of regulatory arbitrage.

We would however like to highlight that specificities might need to be taken into account when it comes to ESG risk management expectations and recommendations. The specificities would have to reflect the type of activity performed beyond the entity performing it (e.g., investment service that is provided both by banks and by investment firms). The framework should treat the same service/activity in the same manner to safeguard the level playing field. An uneven playing field should be avoided and so should be operational challenges (e.g., implementing different regulatory approaches for banks and investment firms in the same group).

Q8: Please provide your views on the relevance and use of qualitative and quantitative indicators related to the identification of ESG risks.

The indicators listed can only provide some guidance. Sometimes it can be difficult to get a grip on certain ESG risks, as they seem to translate quite "softly". Furthermore, new ESG risks can arise quickly.

The DP states (para. 105 page 58) that "*ESG indicators must therefore incorporate information about the transmission channels*", it is unclear what this expectation would entail in concrete terms, as indicators would be used according to their relevance to paint the risk picture.

For example, would it be enough to use the ESG rating (that assess all these issues) or is there an expectation that a disaggregation should be considered? We understand that the supervisor may want also to look into the reasoning behind the way banks assign specific scoring or indicators, however we recommend that the necessary flexibility and proportionality is embedded as to the degree of sophistication expected from the institutions. In addition, it should be made clear that the industry as a whole (and regulators too) is still at an early stage. This means that indicators being concretely helpful for risk control will emerge over time and instead where they proved to be of little use they would be discarded accordingly. Overall, more articulated requirements should only be envisaged in a successive phase.

We also would stress the need to make clearer the link between key risk indicators and key impact indicators, especially when mentioning business models. In this vein there is also a link (even chronological) between impact objectives and impact indicators that should be considered: the objectives are the first to be reconfigured when recalibrating for instance a business model towards a more attentive approach to ESG factors, setting measurable objectives with specific impact indicators.

Q9: 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.

The picture here can only be rather blurry at this stage as our members may each pursue different strategies at this stage. For example, some may be already more advanced with fully fledged internal taxonomies, while others may have in place or in the pipeline sectorial controls on controversial sectors (e.g. weapons' manufacturers or tobacco producers) and emission intensive sectors using company sector code. The supervisory expectations should take into account the lack of (market) standards and the limited availability of data / information.

As to the indicators themselves, an integrated public external ESG rating would be useful to control and capture all relevant aspects of ESG risks in one single variable. The only issue is the coverage of the rating, only available for corporate companies and with no value assigned in many cases.

On climate analysis, GHG emissions for every sector and comparison with Paris Agreement Scenarios, technologies distribution for energy and automotive sectors and physical risk metrics for natural resources dependent sectors will be relevant to assess.

Finally, to translate ESG factors and risks into financial losses scenarios, standardized scenarios could be of support particularly for the less sophisticated and less complex institutions.

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.

Some members indicate that the "portfolio alignment method" would appear as a less suitable method for risk measurement than the other two alternatives. This approach is not risk-based but rather serves as a strategic tool for aligning an institution with a climate target and the associated measurement of target achievement.

How "green" the activities of an institution are in a certain part of the loan portfolio, however, does not allow to derive any direct conclusion about the risk content. For example, financing companies that act sustainably and promote the environment but do not have adequate business management can be associated with increased risks. The distinction between impact and risk must be observed here.

From an alignment perspective it can only be roughly concluded that the institution is exposed to a lower climate-related risk than others who have not aligned their portfolios with the Paris climate goals. However, as described above, a 100% green portfolio may also show a significantly higher credit risk than a "brown portfolio". It always depends on the individual case and the respective framework parameters.

Q11: 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.

Members see how stress testing over a future horizon can be a useful tool to model climate risk impacts, whilst other ESG risks considerations tend to be predominantly more backward-looking. Nevertheless, a guidance on how to implement these scenarios would be of help, in particular the translation of an environmental scenario into losses, as lacking the necessary historical series there is an evident difficulty to set assumptions on how climate scenarios impact the results of companies. Standardised solutions could be of help particularly where banks have fewer resources to develop internal approaches.

Q12: 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.

NA

Q13: 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.

The discussion paper describes three different types of methodological approaches for assessing and evaluating ESG risks (portfolio alignment method, risk framework method and exposure method). Considering limited personal/financial resources and the non-complex business models of small and non-complex institutions these three approaches seem inappropriate.

It must be considered that the entire industry is in an early phase of dealing with ESG risk approaches and, so far, no approaches or procedures have established themselves as standards. Closely related to this is the challenge that the approaches are (still) based on a high degree of subjective assessments. Even if methodological work is being carried out on the objectivity and thus also the comparability of results within the institution itself or between institutions, there is still a long way to go. We therefore suggest that the regulator currently only makes recommendations.

The discussion paper takes this into account to a certain extent and explicitly states that "*The decision on which methodological approach to choose will also depend on the size, the complexity and the business model of the respective institution and consequently the approach taken by a small, non-complex institution will likely differ from the one taken by a large institution*" (para. 109).

However, it should be explicitly clarified in the follow-up to the discussion paper that small and non-complex institutions as defined in Article 4(1)(145) CRR II can apply also simplified, leaner approaches (other than the three laid down in the DP) for the assessment and evaluation of ESG risks.

Q14. Specifically for investment firms, do you apply other methodological approaches, or are the approaches described in this chapter applicable also for investment firms?

NA

Q15. 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.

While generally we cannot conclude that across the board institutions' exposure to ESG risks is dependent on size, and all banks need to perform their own risk analysis, solutions and processes need to be proportionate.

Proportionality is needed, for instance, with regard to the complexity of methodologies and scenario analyses required for assessing the risks. Smaller institutions, but more generally local/regional cooperative banks also of large size, have a retail profile and a portfolio less exposed to corporates, infrastructures and projects; when lending to SME and individuals less or no proper ESG risk assessment can be done as no disclosures and ESG ratings are available. Therefore, it will probably seem that such institutions are not progressing even when in reality for retail exposures they may have done as much as other banks with a different portfolio composition.

Such lack of coverage among tools currently available not only affects the actual results achieved but also the planning process. Banks with a large corporate portfolio will more rapidly progress on the learning curve of sustainability metrics, alignment with Paris Agreement, scenario analysis, etc. by purchasing or applying one of the current tools available, while it would be uneconomic for banks that have a mostly retail orientation to follow that same path as current tools might be or relevance for about 1% of their portfolio of loans. As a consequence, that could give the impression, both to the supervisors and the greater public, that these banks are not moving forward while the reality is that there are no tools out there to evaluate retail exposures and that benchmarking with other banks' business models would not be meaningful.

For this reason, but also in order to provide adequate tools for all banks, supervisors should reflect on simplified tools for banks allowing to treat especially non-ESG reporting SMEs regarding the assessment of their ESG risks.

Q16: Through which measures could the adoption of strategic ESG risk-related objectives and/or limits be further supported?

It is important to raise awareness and knowledge about the ESG risks, including management of these risks, amongst the executives and the management bodies. The management body's (as a collective) ultimate responsibility with respect to ESG risk management should be emphasized. Broad ESG-risk related objectives should be part of the bank's strategic plan.

Also, in this case the "novelty" of the topic must be considered. Banks will need a start-up phase to anchor this topic appropriately throughout the organization. In this context, the lack of relevant data has to be tackled. Currently banks face difficulties in meeting the requirements which in practice cannot be fulfilled, mainly in view of the current lack of clarity of what kind of data should be collected from customer/counterparties and assessed. The data requirements to fulfil an ESG analysis for banks should not exceed the public agencies available information.

A measure in this context could be the set up of incentives for the financial industry to provide capital for the transition. This could be achieved for example through the introduction of a balanced Green Supporting Factor for special exposures (green mortgage loans). Since it is research-wise proven that those exposures are also less risky, by incentivizing the granting of such exposures this measure could generally support the adoption of strategic ESG risk-related objectives and/or limits.

As regards ESG data, it would be important to know what type of data the supervisors consider to be most important/relevant to be collected by banks. The currently available scoring systems differ substantially in terms of quantitative but also qualitative data that are taken into consideration for the assessment of ESG profiles of clients. ESG data is broadly considered to be relevant in the future, but it is hard to decide on methodologies of assessment and eventually impossible to quantify and measure ESG profiles (due to a lack of standardised and unified data, lack of clear methodologies and materiality maps). This is why clarification as to which data is seen as essential by supervisors would be key.

In addition, (notwithstanding the need to specify and unify the data demand) it is also well known that ESG relevant data is broadly not available currently. There is no publicly available data source and most companies do not yet disclose relevant data. A publicly available ESG data hub on EU level would be favorable for fostering transparency and avoiding greenwashing.

Furthermore, supervisors should develop pragmatic approaches allowing banks to adequately treat non-ESG-reporting entities, especially SMEs and come to some kind of (basic) ESG risk assessment.

Q17: Please provide your views on the proposed ways how to integrate ESG risks into the business strategies and processes of institutions.

While we recognize that dialogue with clients based on internal ESG assessments can be an important tool to transition and transform economies towards a more sustainable trajectory (para. 180 & 181), the EBA should clarify that this can only be realized on a best effort basis by the lenders of the counterparty, and in the first place with customers with greater ESG risks stakes or challenges. A systematic dialogue could in fact rather reveal shortcomings: due to the lack of reliable data in the short run, results of the analysis might reveal not relevant (or even unreliable) for some counterparties.

Banks could accompany their clients towards better ESG risks management (§184). However, when it comes to retail customers (§185), we should be cautious not to create expectations which would exceed the bank's mandate and create reputational / liability risks.

EBA also suggests in §223 to enter into a constructive dialogue with critical counterparties, which narrows the range of counterparties with which to set a dialogue. Can EBA specify what is meant by critical counterparties: are they the ones with the lowest ESG performances? The most significant in terms of exposures for the bank?

The dialogue with the industry associations described in §183 should be left at the bank's discretion. As it is time consuming, it makes sense for each bank to focus only on a very limited number of sectors where the bank is driving the market (e.g.: dialogue with the mining and oil & gas professional associations at the time of the discussion and adoption of the Equator principles).

Q18: Please provide your views on the proposed ways how to integrate ESG risks into the internal governance of institutions.

We share the EBA's ideals of integrating ESG risks into the internal governance of institutions. However, we have concerns around several points considered in the discussion paper.

For instance, we see that the collective board responsibility should not be put into question and the level where ESG skills and responsibilities should be allocated should be carefully assessed; a dedicated committee could be a solution only for some banks while in other cases the credit risk committee could be well placed to take into account ESG risks. More in detail we would like to highlight the following:

- **Allocating the responsibility related to ESG risks to a member of the management body**

This recommendation must be in line with the principle of collective responsibility established in some Member States. Under French and Finnish law, for example, the management body should always be addressed as collective, i.e. there should be no obligation to address responsibility to a single member or members of the management body. According to these Member States' legislation, collective responsibility of the management body is indisputable starting point. This would not exclude, however, to establish clear lines of responsibility in the bank. Institutions could only be required to designate an ESG risks reference person in the management body so to ensure adequate attention to the ESG risks at management level.

- **Allocation of Individual responsibility / k<u>nowledge, skills and experience</u> of key function holders (para. 204)**

This recommendation should be considered only at a consolidated level in a cooperative group otherwise it would be very burdensome.

With regard to para. 204 we would also highlight that the reference to "skills and experience" in this context should be better framed. ("*It is equally important that the members of the management body are collectively and key function holders who are individually suitable including that they have sufficient knowledge, skills and experience with regard to ESG factors.*"). It must be noted in fact that it might be too early to fulfil expectations on the level of experience required with ESG factors, as experience in this field has to be built up gradually and skills are refined as institutions progress on the learning curve.

- **One or more ESG committees (para. 203, 205, 206)**

The EBA should not oblige institutions to set up specific organisational structures (e.g. a specialized committee in charge of ESG risks/sustainability). It would be up to supervisors to assess whether the established governance arrangements are efficient. In our opinion, it should be left for all the institutions discretion whether there is a need to establish a separate sustainability / ethics committee of the management body or not. The governance structures of the institutions vary. Centralized or decentralized network/group structures may require different solutions.

- **Training of business units and internal control (p.100)**

Training requirements should be proportionate. Training for all the staff in branches would be very costly and burdensome without proportionality. Online training could be an option. <u>The draft document considers that Internal audit staff</u> should also have the adequate skills and tools to understand and challenge specific decisions. (§212).

- **<u>Principle of proportionality (</u>para. 149, 205, 276, 317) and the conclusion of the Discussion Paper**

Regarding the principle of proportionality, we noticed that the DP at different occasions refers to different criteria. We suggest to harmonize and consider the criteria of the EBA's Internal Governance guidelines.

- **<u>Remuneration (</u>para. 213 and.323)**

At present, remuneration policies are in the focus as a tool for many purposes (gender pay, ESG risk, sustainable corporate governance, etc.)

First, it has to be underlined that the integration of ESG risk into risk-management will automatically make remuneration more ESG-risk related. The EBA GL on sound remuneration practices stipulate explicitly that: *"The institution should define the objectives of the institution, business units and staff. These objectives should be derived from its business and risk strategy, corporate values, risk appetite and long-term interests and consider also the cost of capital and the liquidity of the institution."* Thus, as the current regulatory framework for remuneration practices is very much risk-oriented, the integration of ESG in the risk management and risk strategy will automatically provide also a focus on ESG-risk.

Beyond this, we are of the view that it must remain the responsibility of the financial institution to decide what share of variable remuneration relates to non-financial performance. Furthermore, we think that this solid linkage between the non-financial performance and the remuneration does already exist in the current supervisory framework (CRD IV, GLs on sound remuneration policies). Regarding the recommendations on remuneration practices, we think that 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 elements should not be decided through regulatory measures.

CRD IV, the EBA GL on sound remuneration policies and the ECB Guide on climate-related and environmental risks take a very holistic approach regarding remuneration and in our view stimulates sustainability-oriented behaviors in banks. We are of the view that the current framework ensures that sustainability targets will be reflected in the banks' objectives and business strategy and those aspects would have to be considered as company values in variable remuneration.

Finally, from practical point of view, at this stage, taking ESG criteria into account in variable or deferred remuneration is not possible at least in cooperative Regional Banks as each director has his own remuneration criteria. It can only be done at a consolidated level in a cooperative group, and only for members of the management body or senior management's staff. This could not be extended to risk-takers.

Q19. Please provide your views on the proposed ways how to integrate ESG risks into the risk management framework of institutions.

While we welcome the fact that EBA recognizes that stress tests are still a rather exploratory exercise to trigger capital requirement decisions, stress tests can nevertheless give very different results depending on the scenarios which will be tested (smooth convergence, rapid convergence, no convergence). EBA should specify that such results could only be used, even qualitatively, by the regulators provided that they have defined a common set of assumptions and scenarios.

Like regulatory constraints, ESG standards could evolve in the long term and become more stringent (para. 313/315). In that context, the assessment of long-term resilience could only be performed using current standards. Running stress scenarios of standards/rules could be also challenging for E (except the Climate perspective), S & G, beyond a 10 years horizon.

As to pricing (e.g. para. 133, 253 254) we would like to highlight that pricing reflects risks, perceived or real. As long as ESG factors (excluding physical risks) do not translate into risks, it will be nearly impossible for institutions to move against market and increase pricing to poor ESG performers. The EU and Member States, on the other hand, have the necessary powers to induce poor ESG performers to ramp up and foster sustainable economic development: i.e. corporate regulation, fines, and taxes. Banks can accompany and complement EU policy, but they cannot be substitutes to a potential lack of political action. Besides, a clear distinction should be established between acute and non-predictable events (black swan), and long-term trends, which have different impacts on prudential risks.

With regard to IT systems, the DP indicates (page 114) that "*institutions should be able to generate aggregated data efficiently on a timely basis to meet a broad range of on-demand requests.*" The EBA should specify that this is expected from banks in the medium term. As long as the taxonomy remains incomplete, the revised NFRD not implemented, stress tests exercises are in exploratory mode, banks cannot develop complete databases and IT infrastructure that will enable "*to meet a broad range of on-demand requests*". Institutions will need to include the conclusions and main findings from all these exercises to see which data are most useful to be systematically included in the databases and then start building historical series.

It should be further clarified what type of mitigating tools for ESG risks are regulators thinking about and further details would help. Also, it should be clarified whether the monitoring needs to be focused on global management KPI's or more linked to individual loans monitoring.

Q20. 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.

All companies and sectors are affected in a very similar way for S and G factors. However, due to the seminal stage of development in risk tools in this area and the broader lack of standardization of disclosures and information, we believe that the integration on scenario analysis and the inclusion of S and G factors in risk management is very complicated.

Therefore, focusing on regulatory approaches for climate and environmental risks appears sensible and understandable as a first step. Otherwise, the high complexity of regulatory developments in this area could pose major challenges, especially for SMEs.

S and G risks can only be looked at from a very wide angle, some members report for instance that they have an approach on leaders and laggards instead of a sectorial vision of the risks.

On the other hand, environmental risks and especially climate change related risks the transition risk is of much impact due to the technology requirements or compensation of emissions cost for adapting to new regulations or market expectations, so we believe that climate transition is more disruptive than S and G transition. Moreover, a sectorial approach is possible due to the sectorial difference between industries regarding climate risk. Finally, in the sectors of most relevance for climate risk impacts are associated with their core business (change requirements for the technologies used and even the complete avoidance of core production).

Q21: 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.

NA

Q22: Please provide your views on the incorporation of ESG factors and ESG risks considerations in the business model analysis of credit institutions.

Regarding Chapter 7 (ESG factors and ESG risks in supervision) and in particular with reference to Qs 22 and 23 we would highlight the following. The basis for the inclusion of ESG risks in the supervisory review process is not sufficiently evident. We understand the need to include ESG risks into the institutions' business strategies and processes, internal governance and risk management, however a more substantial approach is needed as the outcome of the supervisory review process usually translates into measures to be implemented by banks.

With regard to inclusion in the SREP, we believe that further clarification is needed as to whether the ESG risks would be embedded in the business model analysis only or in each of the pillars. Generally, we would not see appropriate to include a separate SREP pillar, as ESG risks materialize into prudential risks and should be included in existing risk categories. In this regard, when indicating that ESG risks materialise through their impact on prudential risk categories (see para. 38 and 98) it could be clarified that prudential risks are Pillar 1 risks. In this context it also needs to be resolved how "*a new area of analysis in the supervisory assessment*" is to be understood regarding the long-term resilience of the business model.

We would also point out that new SREP Guidelines should not be applicable before all other connected elements and regulatory pieces have been published and a sufficient period for implementing the new requirements has been ensured.

For example, some EU banks are operating in the CEE Market with several geographies and facing a very different environment (and the same could be said for other relevant markets). We there see the following problem: in such regions there are not the same levels of policy incentives for a green transition, there are fewer reporting and disclosure requirements and typically lower regulatory standards of environmental protection, etc. This might make it significantly harder for banks operating in these markets to fulfill the supervisory requirements towards a reflection on ESG risks for their activities in these regions. The question then would be how can a future revised SREP process including ESG criteria guarantee a level playing field (at least intra-EU) independently from the geographical scope a banking group is working in.

The range of ESG indicators is enormous and all factors cannot be considered at the same time. From our point of view, it should be up to the banks to decide which priorities and thresholds they set for individual factors.

Q23: 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.

Since EBA refers to long-term and timeline of public policies the question of time horizons remains an open issue. We understand that the main objective is to cater in the strategic planning for the transition risk, but we also see that such timelines cannot be stretched indefinitely. We rather see that say a 10 years horizon should be seen as a maximum, also in light of the existing 2030 targets in the EU and in consideration of weighted average maturities of portfolios.

We understand that metrics and scenarios for assessing ESG risks naturally tend to a longer-term view than the typical 3-years scenarios (e.g. 10-years, as to focus on the 2030 targets). Nevertheless, the ESG strategy should be integrated in the business model creating a holistic risk framework for the credit institution; keeping this in mind, maintaining strategies with a 3-years horizon, as included on the business plan, is the best option for a holistic business management that encompasses all other risk metrics.

Setting new targets when reviewing the strategic business plan is more useful and a more pragmatic approach than changing the scope for ESG risks in the business plan.

With regard to the inclusion of ESG factors in internal credit models (PD, LGD – see para. 233 and 325), it is evident that the lack of historical data can only lead to a progressive adjustment of models as factors become statistically significant, as credit models by construction lag behind credit events. At the same time, we would stress that the challenge remains for the calculation of PDs as these are calculated over a 1-year horizon according to the Basel framework. The EBA should clarify that the intention is to rather start reflections in this area, possibly keeping in mind the LGDs where application of factors over longer time horizons could be done more effectively.

Q24: 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 view of enhancing the existing supervisory reviews with ESG factors and introducing a new area of supervisory analysis, we believe there should be a transition period before the new requirements are fully taken into account in the supervisory review process. Also, more differentiation is needed in the process depending on the degree to which ESG factors have influence the type of risks (i.e. just like for other risks, the intensity of the supervisory engagement must be consistent with the actual risk profile).

Q25: Please provide your views on the incorporation of ESG risks considerations in the assessment of risks to capital, liquidity and funding.

As to the modelling and liquidity planning, we would like to reiterate that ESG risks are being approached from a medium/long term perspective, while liquidity risk is mainly a short-term risk (even very short-term). It seems rather a mismatch consider integrating e.g. specific climate risks variables in the liquidity assessment. The management of climate-related and environmental risk should focus on the impact of physical and transition risk on the capital and liquidity position of banks: this means that even if in a given case the climate-related or environmental impact of the activities of a customer may be considerable, this would not automatically imply that the capital or liquidity position of the bank is affected to the same degree.

We would also note that from a liquidity perspective the pace of changes is relevant as liquidity portfolios can (typically) be adjusted over short periods to adapt to a new situation.

Thus, while liquidity portfolios should adapt without losses to transition risks, and while physical risks might occur much more suddenly but impact in particular the value of certain assets, from a liquidity perspective these aspects remain largely manageable.

In para. 339 EBA suggests banks should assess differently a project financing with high ESG performance led by a client with low ESG performance and the same project led by a client with high ESG performance. This comes in contradiction to the taxonomy philosophy, where financing of improvement measures (Capex and, if relevant, OpEx) can be counted as Taxonomy-aligned if they are part of an implementation plan to meet the activity threshold over a defined time period.

EBA should also clarify whether this paragraph only covers specialized lending in the form of project financing or all specialized lending, including asset financing.

Q26: 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 would like to reiterate a number of elements, already expressed under the previous questions (see Q15, Q13, Q11, Q19), that we believe are key in designing proportionate solutions when addressing ESG risks.

At a general level, we would like to stress once more that institutions with a strong retail focus and a portfolio less exposed to corporates, infrastructures and projects may be at a disadvantage when having to fulfil requirements and disclose information.

When lending to SME and individuals less or no disclosures and ESG ratings are available. While it may then seem that such institutions are not progressing in their ESG management, in reality it would be an issue of data.

Such lack of coverage among tools currently available not only affects the actual results achieved but also the planning process. Banks with a large corporate portfolio will more rapidly progress on the learning curve of sustainability metrics, alignment with Paris Agreement, scenario analysis, etc. by purchasing or applying one of the current tools available, while it would be uneconomic for banks that have a mostly retail orientation to follow that same path as current tools might be or relevance for about 1% of their portfolio of loans.

The EBA recommendations regarding the integration of ESG risk into risk management should also be tuned with the potential outcome of the NFRD review[1]. This will be crucial to see what kind of information would for instance be made available by SMEs. As mentioned above, the EBA should envisage pragmatic approaches how banks should deal with non-ESG-reporting entities.

In fact, while most of our members in principle see that all companies should provide NFI reporting, it is also evident that the approach to be taken in that respect should reflect Art. 3 and 36 of the Accounting directive 2013/34: i.e. a very differentiated framework should be developed for micro-companies, small companies, and for medium and larger companies, all based on a common methodology. The Commission has not yet indicated a clear direction in this regard, which makes the information collection efforts of banks all the more burdensome. We could imagine that more time is granted to smaller companies, especially micro companies, to report under NFRD as they gradually become able to produce the relevant data on a permanent basis.

We also would flag again that, while the discussion paper describes three different types of methodological approaches for assessing and evaluating ESG risks (portfolio alignment method, risk framework method and exposure method), in light of the limited personal/financial resources and non-complex business models, it should be explicitly clarified in the follow-up to the discussion paper that small and non-complex institutions as defined in Article 4(1)(145) CRR II can apply also simplified, leaner approaches (other than the three laid down in the DP) for the assessment and evaluation of ESG risks.

Less sophisticated institutions would also need support in the implementation of stress testing scenarios and the translation of an environmental scenario into losses, as lacking the necessary historical series there is an evident difficulty to set assumptions on how climate scenarios impact the results of companies. Standardised solutions could be of help particularly where banks have fewer resources to develop internal approaches.

Also, as long as the taxonomy remains incomplete, the revised NFRD not implemented, stress tests exercises are in exploratory mode, banks cannot develop complete databases and IT infrastructure that will enable “to meet a broad range of on-demand requests”. Institutions will need to include the conclusions and main findings from all these exercises to see which data are most useful to be systematically included in the databases and then start building historical series.

Q27: 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?

Currently we do not see other potential channels. The projects that have already been initiated to regulate ESG aspects (e.g. Taxonomy Regulation) should be taken into account while final publication of Level 2 measures is awaited. Institutions should then be given time to implement (e.g. subsequent entry of ESG data

1 http://v3.globalcube.net/clients/eacb/content/medias/publications/position_papers/green_sustainable_finance/2020/eacb_key_messages_nfrd_consultation_20200612.pdf

on existing business) and to adjust the existing risk management systems if necessary. Before that, it would be too early to aim for an anchoring in the Supervisory Review and in the CRD.

Q28: 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.

NA

Q29: 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.

Annex 1 includes a non-exhaustive list of ESG factors, which should not be seen as mandatory. Moreover, since ESG factors are defined as (neutral) 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, the ESG factors listed in Annex 1 should have the potential to materialize in a positive or a negative way.

However, some of the listed ESG factors have a strong negative connotation. It is hardly imaginable, how these factors can have a positive impact on the financial performance (for example heatwaves, floods, biological hazards etc.). Hence, we are of the view that some of those ESG factors should be formulated in a more neutral way in order to be in line with the definition of ESG factors.

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