ECB Guide on Climate and Environmental risks – AFME and ISDA response (general comments)

September 2020

Context

For the second year in a row, the ECB has identified climate-related and environmental risks as a key risk driver in the SSM Risk Map for the euro area banking system. This 4-month consultation of the ECB Guide to climate-related and environmental risks details how such risks should be managed by banks. **As part of a supervisory dialogue in 2021 based on end-2020, significant institutions will be asked to inform the ECB of any divergences of their practices from the supervisory expectations described in the document ("self-assessment")**. Where needed, significant institutions will be expected to promptly start adapting their practices. The industry[1] sets out its general comments submitted as part of the consultation response below.

General Comments

The ECB should postpone the supervisory dialogue by one year (2022) and adapt the implementation calendar based on the following rationale:

- **Consistency with regulatory timeline and work**: The EBA has not yet fulfilled its mandate given by CRR2 to include ESG factors in SREP and reflect on the prudential treatment of sustainable finance assets. The EBA Guidelines on loan origination explicitly referenced in the guide, were finalized in last May and will be applicable by 30/06/2021 with a transitional arrangement of up to 3 years. In addition, the EBA guidelines on internal governance are under review.
- **Accounting for the progress level of banks.** While the ECB should generally provide a top down guide to support a phased approach, a degree of flexibility should be maintained to take account of differences in individual banks portfolio composition and individual materiality assessments, particular when considering a phased approach to the scope of clients. During the supervisory dialogue we recommend the ECB take account of the following, staggered approach taking account of each bank's level of development and business model**:**
    - **(i)** the nature of climate and environmental risks (noting that banks are more advance regarding climate risks due to the regulatory and research environment);
    - **(ii)** the risk typology (each bank may have different sensitivity or focus in relation to credit, operational, market or liquidity risk). We would note that it may not be possible for all banks to address all the different aspects in the first instance, hence each bank should be allowed to explain the prioritization it has retained; and
    - **(iii)** the scope of clients (here we note data is more readily available for large corporates than it is for retail clients. Again, banks will not be able to implement all ECB's expectations at the same time especially given data availability differs from one client segment to the others. Although banks ultimate goal is to cover the full scope of client segments, each bank will need time and adopt a sequencing on the implementation based on its own calendar and constraints)
    - **(iv)** the geographical presence of banks and the varying maturity of countries regarding climate risk (e.g. different de-carbonisation targets in different jurisdictions).

[1] The Association for Financial Markets in Europe (AFME) and the International Swaps and Derivatives Association (ISDA), are collectively referred to as 'the industry' for the purpose of this response.

While the guide aims to cover both environmental and climate risks, we note the assessment of environmental risks is at a very early stage compared to that of climate risk. For instance, the ongoing ACPR exploratory stress test is dedicated to climate risks only. In addition, the Expert Group of the European Commission has issued a report covering only 2 out of the 6 objectives, climate change mitigation and climate change adaptation, but not yet on the other 4 which relate to environmental risks. Work will focus this year on the technical standards relating to these 2 climate objectives. This is partly due to the lack of data and scientific consensus on methodologies to assess biodiversity risks. This also reflects the complexity of the issues meaning banks are building their knowledge incrementally starting with climate risks which is at the most advanced stage. We therefore suggest this incremental approach is more clearly reflected in the guide. It should be clearly indicated that expectations should be met first in relation to climate risks and then for environmental risks.

With regard to biodiversity in particular, we highlight the understanding of the interaction with the financial system is still nascent and consequently the metrics for measuring the impact such as the Taskforce of Nature related Financial Disclosure (TNFD) are not yet established. This should be reflected in the level of expectations.

It could also be useful to have a definition of environmental risks just for the purpose of this guide, until a more uniform one is adopted as we understand the EBA is looking to do.

- **Data availability as a pre-requisite:** Assessment methodologies will depend on the availability, reliability and standardization of client's non-financial data and external data providers (where neither the bank nor the client can produce such data). Banks should therefore not be expected to have such methodologies until the NFRD (which will for instance support availability of such data) is finalized. Indeed, the ECB should recognize the current level of data quality - until this can be improved we urge expectations to be realistic and not lead to the imposition of expectations such as those drawn from COREP and other regulatory reporting and analytical exercises. Given the development of data in this area banks should only be required to supply it on a "best endeavors/best efforts" basis until the availability issues are addressed.

The guide should clarify that, for the purposes of the initial gap analysis, **JST outcomes should serve as non-binding opinions to support** banks in promptly adapting their practices, and that these opinions **should not lead to supervisory prudential add-ons e.g. via SREP** in the primary instance. In the longer term, the **ECB should acknowledge that climate & environmental factors can have both positive and negative effects**, potentially acting as risk mitigators or risk drivers. Consequently, **ECB guidance should refrain to promote or apply any negative implication on capital** of these factors until the EBA finalizes its assessment or legislators adapt the approach as level 1 regulation.

The level of application of this Guide should be at group consolidated level, while (when relevant) some perimeters might be explored by carrying out deep dives rather than applying the Guide at a sub-consolidated level. In particular, the ECB should be mindful of international banks operating in the EU, which are applying their climate and environmental policies at their global consolidated level and is supervised accordingly.

Alongside the risk materiality concept already introduced in the Guide, **better proportionality should also be taken into account**. Different types of asset classes should not be treated as a one-fits-it-all-approach and flexibility should be embedded for where reporting is done and the level of granularity. Additionally, banks should be allowed to reflect in the requirements the geographic maturity regarding climate risks (e.g. different de-carbonisation targets in different jurisdictions). While it is recognized that requirements between SIs and LSIs may require different levels of application, the ECB should be mindful of maintaining a level playing field between these types of institutions. It should also be made clear that inspection teams cannot use examples given in boxes in the Guide as the supervisory "general rule", without taking into account the context and scope of the credit institution. Alongside this a phased approach should support the proportional application and will facilitate better alignment with other regulators and supervisors.

Environmental risks tend to materialise in long term horizons and should therefore not unduly impact short / medium-term risk profile of clients. They may be integrated into clients' risk assessment as a qualitative assessment to help understanding client sensitivity to environmental risks in the long term. It should also be noted that undertaking a quantitative impact assessment for climate-related and environmental risks at the same time on financial rating might be challenging.

Banks should not have to adapt their pricing based on the climate and environmental related performances of their clients as methodologies are still at too early a stage of development. As long as the client's environmental and climate related performance cannot be quantified by a credit rating, it cannot be linked to clients' credit risk, therefore banks should not be required to adapt their pricing to take climate risk into account. If EU banks are required to adapt their pricing in this way it would distort the level playing field. We consider changing the pricing strategy should be an option for banks but not a requirement, as has also been recognized in the final EBA GLs on Loan Origination and Monitoring. **The integration of ESG factors should facilitate banks to shift towards more sustainable activities,** but it remains up to banks to manage their risks correctly while providing adequate pricing to the client, so that such activities remain soundly managed by regulated actors. Likewise, additional time is needed for experimentation and for standards and common KPIs / KRIs to be established.

Pillar 2 models developed for climate and environmental risks will have to follow the general principles on Pillar 2 models as described in the ICAAP ECB guide. Principle 6 of the guide (in particular the section on independent validation) requires Pillar 2 models to be built using the same conservativeness as Pillar 1 models. This requirement means that it will be practically impossible in the short term to integrate climate risks within Pillar 2 models unless the independent validation requirement is lessened and applied in a proportionate way. Therefore, the ECB should clarify that for emergent risks, such as climate risks, less stringent rules than those of the ICAAP ECB Guide should be allowed for Pillar 2 models, with regular review of assumptions and methods.

The ECB should confirm that it does not intend to modify the 3-year time horizon for the ICAAP although banks should consider the impact for longer horizons which can be addressed qualitatively.

The ECB should clarify that the Guide's main focus should be on financial materiality (impact of climate related and environmental risks to the bank) and set out more clearly the way in which banks take into account the effect their operations could have on its environment and to what degree.

Governance and the need for a holistic approach: Governance around climate-related and environment financial risks should rely on existing general provisions and expectations. In particular, institutions should have the flexibility to leverage governance structures at group level to ensure a consolidated approach to climate related and environmental risks. The ECB should therefore confirm that the guide does not require banks to set up a separate governance structure for climate risk and that existing governance may incorporate climate risk (e.g. existing Risk Management Committee of the Board should have oversight of climate risks along with other risks), unless a bank deems it appropriate for their specific governance structure. In so doing this should avoid duplication of general risk managements requirements as set out in the EBA guidelines on internal governance for the purpose of environmental and climate related risks (currently under review).

Climate and environmental risks as driver of existing risk categories: As stated in chapter 3.1. – 3.2. climate and environmental risks are being understood as risk drivers and aggravating factors of existing risk categories such as credit, operational and market risk. However, the application is not consistently reflected throughout the guide - several of the expectations of the ECB are formulated in such a way that climate and environmental risks could be considered as a separate risk type. For example: the materiality assessment of climate risks (exp. 1.1), KPI-set (exp. 2.2.), limits for climate risks (exp. 4.1) etc. The guide should make clear that climate and environment risks only needs to be integrated into existing risk framework while retaining flexibility for banks which wish to treat them as a separate risk type if they deem it appropriate to their risk management framework and business model.

We consider scenario analysis as an adequate tool to assess environmental risks and potential effects on banks' business environment and strategy resilience. Nonetheless, in taking this approach the ECB should be clear on what requirements chosen scenarios need to fulfil. **Such an exercise should be focused on common material risks and not adopt an excessive number of scenarios**. These scenarios should also be considered as "possible futures", to enlighten business strategy in the long-erm horizon to better manage and determine how they may respond to different potential scenarios but are not always appropriate to take definitive decisions. In this respect we would emphasise that no agreed methodology exists today, and the current focus is currently on climate transition risks with little progress on climate physical risk scenarios and nothing in relation to other environmental risks. Many EU banks are today actively participating to the exploratory pilot exercises proposed by the EBA or their national supervisor (ACPR and Bank of England), which present three different approaches. Banks and regulators are therefore at a testing and learning stage on this very topic. **As a result, we should consider the results of scenario analysis and stress testing with caution and the preliminary findings should not give rise to formal expectations at this stage.** Furthermore, we welcome the work of the NGFS to develop scenarios and consider the ECB should take this into account as standardization of scenarios is important and a pre-requisite to comparability of assessments. It will be important to have a clear set of common base-line set of scenarios to drive comparability but still allow banks flexibility to also use additional scenarios if they choose and apply greater granularity to tailor at an individual level to address their own identified portfolio vulnerabilities.

Regarding **disclosures**, we support the ECB's proposal to apply a recognized international reporting framework, namely TCFD, which many banks are already reporting voluntarily, yet the guide refers to the NFRD. It should be recognized that the EC non-binding guidelines to the NFRD have gone beyond TCFD recommendations in some instances (e.g. references to "forward looking estimates" of carbon related assets and carbon intensity of portfolio). **Thus, we would welcome a clarification that the ECB does not intend for the "non-binding" guidelines to become de facto mandatory via this guide. This would be disproportionate particularly when the guidelines go beyond the international standard.** In particular we would welcome confirmation that under expectation 13 of the guide, financial institutions are only expected to choose KPI from the non-binding guidelines according to a materiality assessment. Likewise, to address the current lack of data and difficulties to calculate scope 3 emissions, a phase in by sectors for scope 3 emissions should be considered, to come into force when the methodologies are agreed and disclosures are adequately standardised.

Additionally, we would request alignment between these disclosure requirements, the requirements under the NFRD revision in 2021, and the EBA Pillar 3 requirements in 2022. In finalizing the guide, it therefore would be useful if the ECB could set out what the future intentions are for incorporating changes and updates to existing disclosure requirements to help banks forward plan. In the meantime**, banks should be given flexibility to build reliable KPIs on follow-up to climate-related risks and implementation of climate strategies until the other requirements become clear.**

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About AFME

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About ISDA

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