## AFME-ISDA Consultation Response

### Consultation on EBA Discussion paper on management and supervision of ESG risks for credit institutions and investment firms

3 February 2021

**General Comments/ Introduction**

AFME and ISDA (hereafter the "associations") welcome the opportunity to comment on the EBA's Discussion Paper on the management and supervision of ESG risks for Credit institutions and investment firms (hereafter referred to as the 'DP'). This discussion paper comes at a time of intensive work on multiple fronts to assess and address how banks best reflect and integrate their own climate risks and those of their clients into their business models and future planning. It is particularly welcome that this discussion paper recognises the interwoven aspects of climate risk policy under development – disclosure, taxonomy, corporate governance including due diligence, risk management, stress-testing and supervision – which are all key pieces in developing a consistent and coherent climate risk framework. We look forward to constructively engaging on how to incorporate these policy considerations within the work of the EBA on a reasonable time frame, noting that the impacts arising from climate risk could extend far beyond the usual maturity of banks' assets. We would also note that banks are at the very early stages of incorporating these risks into internal processes, systems and data collection, which will therefore require a considered phase-in approach.

The DP acknowledges several important aspects of climate risk management which banks are considering in depth and we respond to in the questions set out in the consultation. Nonetheless we would like to highlight the following issues:

- **The EU Taxonomy:** the EBA has incorporated references to the EU Taxonomy into the consideration of ESG risk management. We understand that the reference is intended as an illustrative example for the purpose of this paper. While the associations fully support the Taxonomy as a useful tool for banks to identify opportunities to invest in green activities, it is not appropriate as a risk management tool and we recommend the purpose of references to the Taxonomy should be clarified in the final report. The EU taxonomy is part of banks' adaptation to a more sustainable economy and relevant for disclosure purposes only, not for the prudential consideration of ESG risks.
- **ESG risks as drivers of existing risks:** The EBA provides a very useful clarification on this point, which has been well recognised and addressed in the DP, in particular in relation to how governance structures are intended to work, though minor amendments might be necessary on some aspects. We would also emphasise the need for a proportionate approach, which recognises the different level of development of climate and environment risks for risk types (e.g. liquidity may be less necessary to address in the first instance than credit risk).
- **Definitions of ESG risks, factors and transmission channels:** This is strongly welcomed as something that the associations have been asking for. We think the approach taken is a good basis to work with, but some further considerations might be needed, such as the consideration of positive effects of ESG factors, the double materiality aspect, and counterparty scope, among others. In relation to the

appropriate consideration of 'Double Materiality' specifically, the EBA recognises the concept of double materiality as advanced by the NFRD. Nonetheless, there are some considerable challenges in implementing this, which will need careful consideration of how banks can practically incorporate this concept.

- **Methodologies and KPIs:** The EBA has taken a non-prescriptive approach to methodologies and KPIs, as well as acknowledging the difficulty of integrating ESG risks into current models based on historical data. We welcome the extensive analysis and approach that has gone into assessing these methodologies and consider that a flexible approach is suitable for now as banks work to establish the most appropriate mix and use of methodologies for their business models. It is important that banks are granted full flexibility to develop internal methodologies given we are still at an experimental stage and trial and error is an important part of improving methods to get the best outcome, which may differ across banking business models. We note there will also be a consultation from the Basel Committee in the course of 2021 and it will be useful for global cooperation on this topic. We would welcome the opportunity to further engage on this to provide insight to the different approaches as banks gain further experience. In due course it will be important to discuss common methodologies and scenarios, but it will take time and should not limit the current testing approach to development.
- **ECB guide on Climate and Environment risk:** While the ECB final guide did not address all of industry's concerns submitted in the consultation response (see Annex 1 for an overview of these issues), we think that now the guide is finalised and firms will be required to provide a gap analysis in 2021, the EBA should be consistent with it in the DP outcomes and policy recommendations.
- **Corporate Governance:** The European Commission is currently consulting on the Proposal for an Initiative on Sustainable Corporate Governance, which explores a possible introduction of mandatory due diligence requirements by companies in respect of potential or actual adverse impacts from business activity onto environmental, social and governance factors. We call for the EBA to consider this initiative in its final recommendations following this discussion paper and to coordinate with the European Commission on this subject to ensure coherence and consistency of the two frameworks in terms of their application to financial institutions.
- **Phasing-in:** It is important for the EBA to set out how the DP outcomes should be phased-in especially given the challenges of data collection. AFME and ISDA's response also highlights a number of other areas where this will be important, in particular for the SREP (Chapter 7).

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

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

To identify other relevant frameworks for ESG factors that banks already use beyond those mentioned in the Consultation Paper, we suggest making the following distinctions:

1. Frameworks included as reference documents in our 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.

- Task Force on Climate-related Financial Disclosures (TCFD).

2. Frameworks to be considered case by case, when needed, namely:
   - Sustainability Accounting Standards Board (SASB)
   - Climate Bond Initiative (CBI)
   - ICMA Social Bond Principles (SBP) and Green Bond Principles (GBP).
   - LSTA Green Loan Principles (GLP).

3. EU frameworks that will operate alongside the output of the final EBA report on ESG:
   - ECB guide on climate and environmental risks
   - Member State guidance on climate risks (e.g. Bafin guidance notice on dealing with sustainability risk).
   - The EU Taxonomy (in as far as it is relevant for disclosure purposes only)
   - EU Sustainable Corporate Finance initiative outcomes

With regard to the ECB guide on Climate and Environmental Risk which has recently been finalised, banks are required to start assessing alignment and complying with it, however this is not mentioned in detail in the DP. We understand both the ECB guide and the final output of the EBA DP on ESG risks will be the basis for supervisory dialogue and purposes and it is important that both regulators are aligned in terms of definitions and approaches for climate and environmental risks (or areas where these two overlap). It would be useful for the final report to clarify how it interrelates with the ECB guide and other Member State specific guidance in place for the purposes of supervisory dialogue and assessment.

There are many initiatives covering ESG factors and ESG risks, therefore an aligned definition of ESG factors and risks is central to finalising the standardization of existing initiatives and further integration of current initiatives in place. At the same time, as mentioned in the DP, the identified ESG factors (and their associated risks) are likely to evolve over the time, so we are of the view any policy framework should be flexible enough to adequately address emerging issues in the transition to a sustainable economy.

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

We support the definitions of ESG factors and risks, in particular we welcome the additional information and explanations provided on what is considered a “factor” and the recognition that ESG factors may have both positive and negative impacts, though they are driven in terms of risk. In addition, we have some considerations on how to further clarify these definitions set out below.

We support the definitions of ‘s’ and ‘g’. With respect to the definition of ‘e’, it seems likely that further work could be done to define the factors underlying the definition of ‘e’, especially with a view to make these factors widely relevant and create greater distinction from operational risk types.

We support the integration of litigation and legal risks as part of operational risk, which are transversal to all ESG risks (meaning it should not part of transition risk anymore, §86/90 & 242).

We note that labels and norms are still under construction, banks will use external data where available to eventually integrate them within their internal policies. Generic indicators such as a single "ESG" rating would be welcomed but should be used cautiously as it could cover differentiations with regard to a separate appreciation of E, S and G risks (§134). Both ratings could be used as a positive or negative assessment of the counterparties.

We would also urge caution regarding the risk of double-counting the ESG risks as part of these risks are already embedded in banks' policies, or external ratings already in use (§137). This should be provided for due to the fact that ESG risks are not their own risk-type but a risk-driver influencing all 3 'traditional' risk types.

**Application of scope to banks' counterparties**

Regarding the scope of application there are a number of considerations that could be clarified in the final report of the EBA:

- It would be useful if the EBA included the broadest possible scope of ESG factors, their applicable transmission channels and how they manifest as drivers of existing risk categories, for instance this could be in line with table 1 of the ECB Guide on C&E risks.
- The DP focuses the scope of application and definitions on banks' counterparties. However, the DP does not clarify if banks should consider the impact stemming both from internal operations and financial exposures in the instance of other financial institutions (FIs) as counterparties. This should be made clear in the final report, as well as whether the reputational risk linked to the counterparties financed is included in the scope.
- The suggested definition of ESG Risks focuses on the definition of ESG Factors and thereby on the features of the counterparties of the institution alone (consistent with the scope of the DP). It may be considered that ESG Risks may also materialize via events that are not related to a counterparty. For example, a strict interpretation of the definition of ESG Risks suggests that the consequence of adverse weather conditions on crop prices would not be an ESG Risk as the risk is not channelled directly through a counterparty. Additionally, ESG Risks could potentially affect the bank directly, e.g. the reputational consequences of not meeting society's expectation on ESG standards. Moreover, the focus on counterparty related ESG Risks, may under-estimate the manifestation of ESG Risk in the Business Model (risk) of financial institutions. Hence, we observe that the DP implicitly focusses on *ESG Counterparty Risks*. It could be considered to explicitly define *ESG Counterparty Risks* rather than ESG Risks. This could also support the aspect of the definition that "*ESG risks materialise themselves through their impact on prudential risk categories*", whereby the definition-element is clearly not valid at the group level of the institution, but indeed very helpful to consider how counterparty related ESG Risks may materialize. We would suggest how these other features of ESG Risks could be separately discussed in the follow-up work of the EBA.
- Finally, the distinction between ESG factors and ESG risks requires some clarifications. While the definition of ESG factors is 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, the introduction of the notion of ESG risk confuses this. A credit risk that is triggered or aggravated by one or several ESG factors does not change the intrinsic nature of the risk type, it remains a credit risk. Hence, it may be important to identify situations where credit risk events are triggered or aggravated by ESG factors, however, they do not become ESG risk events because they are "coloured" by ESG factors, they are still credit risk events. Specifically, where the EBA defines ESG Risks as "risks of any negative financial impact to the institution stemming, from the current or prospective impacts of ESG factors on its counterparties", this could be mis-interpreted as meaning all scenarios / risk events that lead to negative financial impacts for the institution should be considered as ESG risks no matter what their intrinsic risk types are (credit, market, operational...). We therefore suggest the EBA clarifies in paragraph 34 the concept of ESG Risks in relation to "risk events triggered or aggravated by ESG factors".

**Double Materiality threshold**

One aspect we consider challenging is the concept of double materiality, which we acknowledge has already been introduced in the NFRD. The challenge arises from measuring and managing both in terms of environmental & climate (i.e. emissions) and also in "social" risks, when considering the full value chain in a company's production cycle both upstream and downstream. For example, although larger companies may be better placed to provide assurances (of a limited nature), for smaller entities it is highly burdensome to expect them to understand the "social" practices of all their suppliers. A bank can only rely on available information (be it disclosures by the companies, external tracking services – e.g. Reputational Risk, rating agencies), but even then, sources of information may be limited (e.g. it is not necessarily possible to cover all the countries where a company operates). It is unclear to what extent the environmental and social materiality will be considered in the scope of the DP and potential outcomes and how to assess materiality. In the case of "governance" risks, a similar argument applies. Large public or private companies subject to stringent reporting obligations will be more easily assessed than smaller companies with limited disclosure requirements. We also note that the European Commission is currently consulting on the Proposal for an Initiative on Sustainable Corporate Governance which is exploring a possible introduction of mandatory due diligence requirements by companies in respect of potential or actual adverse impacts from business activity onto environmental, social and governance factors. We will be happy to provide the EBA with our response to the consultation once it has been finalised on February 8, 2021. We call for the EBA to consider this initiative in its final recommendations following this discussion paper and to coordinate with the Commission on this subject to ensure coherence and consistency of the two frameworks in terms of their application to financial institutions.

Furthermore, we would note that environmental and social materiality appear to be defined by EBA in the context of financial materiality, e.g. environmental and social materiality is only relevant if its leads to a financial impact on the counterparty of the institution. This interpretation is different to how it is considered in the NFRD 2019 supplement, where environmental and social materiality are defined separately from financial materiality. This could create an extra complexity for disclosures and internal processes where these concepts are understood differently in different contexts, e.g. risk management, disclosures, strategy setting, etc. With the concepts already differing between the generally accepted TCFD framework (only financial materiality) and the NFRD 2019 supplement from the European Commission

(E&S materiality separate from financial materiality), introducing another definition might further fragment the sustainable finance landscape.

Consequently, we consider the scope of counterparties' risks that banks should be able to acknowledge and manage to be limited in scope, especially when it comes to recognising financial materiality and avoid any additional complexity in terms of reporting. If banks are expected to consider the inclusion of all potential ESG risks across the value chain of counterparties/companies, it may disincentivise banks to support those sectors/firms that are transitioning. Moreover, with the aim of moving forward to a more sustainable economy not only at European level, but globally, the integration of ESG factors should be done in a holistic way to avoid improvement of environmental factors to the detriment of social factors. This holistic approach will have to be adapted to the different jurisdictions and companies operating in them. In this respect, emerging countries are going to face the most significant social and governance risks as far as they have not yet integrated sustainability fully into their objectives and priorities. This will particularly affect institutions/entities with a broad international footprint.

**Social risks**

We would note that in terms of "social" risks, the use of the word "**any**" opens financial firms to potential liabilities in the event of failure to identify non-disclosed risks (or even disclosed risks) and this should be avoided. Therefore, we would suggest modifying the wording by using "**identifiable**" instead of "any" in the following sentence:

*"ESG risks mean the **identifiable** risks of negative financial impact to the institution stemming from the current or prospective impacts of ESG factors on its counterparties'. ESG risks materialise themselves through their impact on prudential risk categories".*

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 recommend the negative scope should be amended to take account of the positive risk profile of companies. When comparing individual companies in individual sectors, a positive assessment of the company's management of ESG risks will have a positive impact on the risk profile of the financial institution. For instance, if institutions stop investing in thermal coal mining industries, the labour market in those regions will be in crisis and social risks will materialize; however, in terms of environmental risks there would be positive impacts since those institutions would stop promoting non-green industries. Including the positive potential will provide a blended view of the overall risks and is in line with the treatment of other relevant risk factors (e.g. the management of operational or liquidity risk). Amending the scope in this way would also be coherent with the *Engagement with client's* approach (acknowledging good management of ESG factors by counterparties if applicable) and help establish a virtuous circle and phasing in of ESG risks. The opportunities which are mentioned in relation to transition risk (§65) would appear to be consistent with the supervision approach (§236 & 283). These risks could be considered as emerging ones within banks assessment grids.

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

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| We agree with the proposed definition of "Environmental risks"; however we consider that the description of environmental factors in paragraph 4.3.1 is too limited to climate change. It would benefit from the inclusion of other more direct "here and now" environmental examples that would be better linked to the definition of Environmental risks in section 4.3.2, which also includes factors such as environmental degradation. We support paragraphs 44 & 45 which are important explanations of the interplay between environmental and climate change factors, and it also indirectly touches on "social" aspects (in the example, the impact on local communities which could face water shortages driven by excessive industrial use of this scarce resource).<br><br>We believe the proposed description of physical risks provides a welcome clarification of the fact that "environmental events other than climate change that can drive physical risk" and the examples provided in Box 3 are important to illustrate this. We note that some definitions include/provide specific examples while in other cases more general examples are provided. In this regard, we suggest taking out the sentence "that may damage production facilities and disrupt value chains" as the discussion paper had until this point refrained from including examples in the definitions, and we consider this the correct approach. Aside from this, the proposed definition is helpful.<br><br>Regarding Transition risks, as we have highlighted in relation to physical risks, we also recommend avoiding the use of examples within the definition to ensure the consistency across definitions throughout the discussion paper – we support a "less is more" approach to the definitions as well as the following clarification:<br><br>*"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.*<br><br>Finally, we think a definition of the time horizon would be useful in the context of the bank strategy. While we understand it could be 10 years or more, different references are made to 2030 (more often cited), 2050 and 2100 (e.g. §2 or §314). We would favor a definition of 10 years – a considerable extension of the current 3 to 4 years strategic planning horizon. This time horizon is also compatible with the weighted average life of our assets. E, S and G risks may also have different time horizons (§155). Banks should also be allowed to determine a horizon beyond this if necessary. We would also note on this topic that the interactions between COVID-19 crisis and ESG risks are not straightforward and it is too early to draw conclusions on the long term (Box 5 & question 5). |

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?

We consider the Governance and Social risks definitions to be acceptable, however more clarity is needed on what governance factors mean beyond the examples provided in the text of code of conduct and AML. It is important to have a clear description on governance and social factors to avoid the double counting of governance and social risks that have already been taken into account in the assessment of other existing risks, such as operational risk or credit risk.

Additionally we would like to highlight that provided examples seem to go further than the governance risk scope, for instance “diesel-gate” should be linked to reputational risk instead of governance risk.

Moreover, as previously raised on question 2, we are concerned about the extent to which institutions would have to be aware of social and governance risks when considering the full value chain in a company’s production cycle. The scope of counterparties’ risks that banks are able to acknowledge and manage should be limited; if not, the inclusion of all potential ESG risks across the value chain of counterparties/companies might become a serious obstacle to banks’ financing a range of counterparties (due to high compliance risk), especially those located in jurisdictions where local laws and regulations cannot cater for the degree of disclosure required in the EU. It is important at industry level to have a common understanding of the relationship between double materiality, the value chain with our providers and the direct and/or indirect risks.

With regard to social factors, we would appreciate a more holistic view on the human and social impact of climate change and biodiversity loss.

Finally, we would note that the interactions between COVID-19 crisis and ESG risks are not straightforward and it is too early to draw conclusions on the long term (Box 5 & question 5).

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.

The definition of liability risk should be aligned with the ECB guide. It should incorporate recognition that liability risk can arise without exposure to the counterparties but also through the operations of the institution itself and reflect both effects. The specific aspect of liability resulting from exposure to counterparties should be separated out.

As raised on question 5, we consider more clarity is needed on what governance factors mean to avoid double counting – as we understand it, governance factors may be considered negatively both in the definition of governance risks and also within liability risks.

We would also note that the definition of liability risk does not reflect the risk for investment firms.

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.

In general, we support the maintenance of common and harmonized definitions as far as possible. Having said that, it is worth noting (as stated on page 28) in the case of investment firms the concept of counterparty may be less relevant as ESG risks may manifest through the assets they held as part as of their investment activities in general. Nevertheless, beyond the reference included on page 28 to the asset's investment firms hold, this nuance is not included throughout the rest of the document. We therefore suggest more nuanced definitions within the reference both to counterparty and/or assets investment firms hold to allow it to be used/ applied by both credit institutions and investment firms.

In the same vein, all the examples provided in the document are related to loans (e.g. p.33, 36." loans to agriculture/automotive."). Therefore, we would suggest including examples related to investments as well.

**Quantitative and qualitative indicators, metrics and methods to assess ESG risks (Chapter 5)**

Additional question not included in section "3.2 Questions for consultation" but found on page 53:

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.

Yes, we agree with the sequential steps identified in the discussion paper.

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

We agree that ESG risks need to be identified through qualitative and quantitative indicators. The nature of the preferred indicator(s) will be driven by a combination of factors, for example the nature of the risk, the data available, models available for quantification, scenarios, etc. Both are very relevant. Where quantification is not straight forward or possible, qualitative indicators provide an alternative.

It is paramount that both types of metrics are used together. The qualitative and expert judgment indicators fill current information gaps that are necessary for the quantification and projection of variables. The combination of both may give sense and criterion to the quantitative results especially in the use of models (e.g. the supervisory pilot climate risk scenario analysis).

Additionally, we appreciate the clarity provided during the public hearing on 26th November, explaining the EU taxonomy is not considered as a risk management tool in order to avoid any misunderstanding between different stakeholders. It would be useful if clarification on references to the EU taxonomy could also be included in the final report.

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.

The non-exhaustive list of ESG indicators provided is an important starting point to obtain information on ESG related issues, and it can form the basis for the development of product offerings. Banks have already considered many of them as part of their internal product taxonomy development (separate from a risk taxonomy of sectors/ counterparts/ products). In addition to those mentioned in section 5.1, the sustainable finance disclosure regulation technical standards are expected to include an extensive list of indicators, as is the future label for the European Green Bond Standards for which we are still awaiting the final EC proposal. Nonetheless, many of them are not suitable for risk management purposes for the reasons set out below:

- The EU taxonomy provides a list of activities, but there is no historical data that implies that lending to these activities has a more favourable risk (repayment capacity) profile. A company that engages in sustainable activities may be better positioned from a sustainability/reputational risk angle, but there are many other credit/social/governance factors that can unfavourably affect its financial performance (e.g. unbalanced debt/equity structure, poor product offering, etc.).
- Information on emissions and related information on breaches of existing regulation are important to understand a company's position and forward-looking pathway with regards to decarbonisation of activities. However, emission levels can be easily changed, for example through the sale of activities to a third party or by the acquisition of new activities that can be perfectly legitimate and be transition risk / credit positive.
- Biodiversity markers can also be misleading where they reference "own or via value chain", and are often reliant on full disclosure by companies, as they require geographical information at a level that is not available to banks.

Finally, we would note the aforementioned indicators are EU centric and not applicable in other jurisdictions where banks may operate. It may not be possible to ascertain the applicability of these standards, labels and benchmarks outside the EU.

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.

Our current understanding on the portfolio alignment method is that it relates more to strategy and business opportunities than to risk management, although this is a very dynamic and forward-looking approach, and the information could be used as a qualitative risk indicator of the companies´ transition trends in the medium term. We would also note that the portfolio alignment and risk approach are geared towards climate and little consideration has been given around compatibility with SDGs.

Some banks are considering portfolio alignment method as an initial tool as well as considering other methodologies with external data providers, which provide alignment metrics too. It is also under consideration that this could be a way for banks to reduce exposure to reputational risk by demonstrating their commitment to the Paris agreement objectives.

Nonetheless at this stage the criteria to fully apply some approaches does not correspond with current data availability nor the level of development of the methodologies for banks (which is at a different stage of development to approaches defined for corporates in specific sectors). We would also highlight the heterogeneity in approaches and the difficulties in assessing alignment - in this respect we would note the *Katowice* banking industry initiative may be helpful to address the issue.

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

We agree with the EBA's assessment that methodologies are still at an early stage of development and that they all require a substantial degree of subjective judgement. We fully support the EBA's analysis 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 analysis are a useful and important tool, however given their complexities and many uncertainties, they also need to be assessed and interpreted with caution." (§124).

Consequently, for the purpose of the final EBA report we recommend the "Climate Stress Tests" wording should be replaced "climate risk scenario analysis". Vulnerability to climate risk should be assessed with a limited number of exploratory scenarios, over a much longer horizon (10/30y) on a best effort basis, this should include the supervisor led climate pilot exercises and be undertaken outside the usual stress test exercises.

This would prevent any confusion with the existing EBA Stress Tests (next in 2023) and make it clear that climate related scenario analysis outcomes should not lead to any capital charge, whereas the traditional stress tests result in a Pillar 2G charge. Instead, supervisors may want to apply qualitative add-ons to banks whose awareness and governance of ESG risks is lagging compared to peers, to incentivize them to accelerate their approach. We note some banks are already progressing down the path of sensitivity and scenario analysis related to transition risks, although they closely follow physical risks developments, as it is considered a better risk management approach for measuring climate change related risks both on a portfolio basis and on an individual customer basis.

Banks are also considering and contributing to frameworks (BoE, ACPR, DNB pilot exercises). In the context of the pilot exercises they organize(d), they provide(d) a useful and needed framework (climate scenarios with complete set of macro-economic variables), but they did/do not provide stress calculation methodologies as such (that needed to be developed by banks a least for ACPR).

Finally, we would also welcome a clear regulatory view on whether the use of external provider methodologies will be acceptable either as a long-term or short-term solution taking into consideration that existing limitations to develop in-house methodologies will continue in the coming years. This is important to understand the investment effort in external methodologies and the emphasis of regulators on internally developed models.

12. As an institution, do you use or plan to use an exposure method in your approach to measuring and managing ESG risks? Please explain why and provide details on the methodology used.

We support that an internal assessment of ESG factors has to be performed based on risk criteria at client level, however as mentioned previously and also in our responses to the NFRD and SF strategy consultations, given the lack of existing capacity for in-house developments there is a high dependency on external providers, potentially leading to an increase in market concentration.

The simplified exposure method and possible its reliance on ESG ratings could be problematic and lack comparability. The difficulty rests on the wide variation between ESG rating providers for the same counterparty and the lack of transparency around ESG rating methodologies. Thus, the proposed use of ESG ratings for the exposure method presents a number of significant concerns. Notably, ESG ratings are generally only available for public firms and most private firms would not have an ESG rating that is available.

There should also be consideration of what ESG ratings actually measure. ESG ratings are based off ESG performance and are not specifically geared to downside risk (unlike an external credit rating). Utilising ESG ratings for supervision of ESG risk purposes may result in a misleading picture of a bank's ESG risk profile. Given the initial focus of the EBA on climate risk, we would also specifically call out the lack of climate risk considerations in many ESG ratings methodologies.

Alternatively, we would suggest another method looking at industry sector exposure, with some simplified ESG metrics such as carbon intensity could be a more straightforward way to address ESG risks at smaller firms. We would also suggest that for supervisory activity in relation to ESG risks, that for smaller or more niche institutions there should be consideration of the bank business model and which ESG risks are more likely to manifest, rather than applying a corporate counterparty focused model which is more relevant for larger diversified banks.

13. As an institution, do you use or plan to use any different approaches in relation to ESG risk management than the ones included in chapter 5? If yes, please provide details.

Banks constantly review the methodological developments in the market to improve/complete current/mentioned approaches. Nonetheless, the investment required for any of the approaches implies a certain amount of "no regrets" decisions in the immediate future if they are to meet expectations (regulators, supervisors, stakeholders). This could make sudden changes to the approach costly and potentially difficult to implement.

Overall we welcome that for now the EBA has taken a non-prescriptive approach to methodologies and KPIs as well as acknowledged the difficulty of integrating ESG risks into current models based on historical data. The extensive analysis and approach that has gone into assessing these methodologies is useful and we consider that a flexible approach is needed in order for banks work to establish the most appropriate mix and use of methodologies for their business models. It is important that banks are granted full flexibility to develop internal methodologies given we are still at an experimental stage. Trial and error is an important part of improving methods to get the best outcome, which may differ across banking business models. We note there will also be a consultation from Basel in the course of 2021 and it will be useful for global cooperation on this topic. We would welcome the opportunity to further engage on this to provide further perspective on banks' approaches as they gain further experience. In due course it will be important to discuss common methodologies and scenarios, but it will take time and should not limit the current testing approach of development.

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

In general, we consider the metrics and methodologies described in this chapter are aligned with those approaches' banks are currently using or expect to apply, however they are not described from the perspective of investment firms, in particular the exposure method is probably not applicable for investment firms.

Nonetheless, we consider the analysis performed under both the alignment and the exposure methods should be complemented with an active ownership. Engagement is key in order to better understand companies' strategic plans, how they are managing ESG risks and opportunities, and how prepared they are to face ESG challenges. In this sense, collaborative engagement initiatives like Climate Action 100+ are also relevant for asset managers.

In some cases the DP refers to dialogue with "clients" (for instance in box 10, page 60) which in case of investment firms is not a valid reference as they are not clients, but companies in which investment firms invest in. Therefore, this reference should be updated to reflect applicability both to clients and/or companies in which investment firms invest in.

**The management of ESG risks by institutions (Chapter 6)**

15. Please provide your views on the extent to which smaller institutions can be vulnerable to ESG risks and on the criteria that should be used to design and implement a proportionate ESG risks management approach.

We welcome the inclusion of proportionality principle under some sections of the DP; however we are concerned about the linkage between proportionality principle and the size of institutions in specific paragraphs e.g. §109. We recommend the link to the proportionality principle in this respect should be aligned with that in CRR2, where size of institutions is relevant on the basis of disclosure and reporting.

We think that automatically using size as the determining factor for assessing proportionality should be avoided. Assuming that large or smaller banks are more or less vulnerable to ESG risks simply due to size is not accurate and other criteria should be taken into account such as business model, geographical location, etc. Indeed, smaller (less-diverse) institutions can be even more vulnerable to ESG risk then bigger institutions. For example, a bank specialising in retail mortgages may not hold a large overall market share in its market but may be a locally systemic institution due to its share of the mortgage market. This business concentration may protect from social or governance risks, but it could give rise to higher environmental, transition and physical risks than those faced by a more diversified institution.

On the other hand, depending on an institution's business model, some ESG risks are more relevant than others. The proportionality principle should apply with respect to how the institution develops full internal methodologies for the most relevant risks and simplified ones for less relevant risks identified, at least in the short term.

Finally, the EBA should be mindful of international banks operating in the EU, which are applying their climate and environmental policies at their global consolidated level and supervised accordingly at the EU entity level (e.g. in allowing them to leverage as much as possible their Group tools, methodologies, TCFD disclosures, governance structure to meet local EU requirements that may stem from the EBA's report).

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

We agree with the EBA proposal to measure the adoption of strategic risk-related objectives. In 2020 significant progress was made at industry level in terms of governance at board level providing a holistic view of the relevance of ESG risks and setting internal and external KPIs, as well as external commitments relating to sustainable financing[1].

Nonetheless, in order to be able to set clear limits/objectives, banks need to set strategic ambitions, which hinges on methodologies being developed and, in addition, a clearer regulatory "picture" in terms of timelines and interaction between different regulations. This would be helpful to have a more straightforward view on the strategies and investments in products to meet regulatory requirements. Clear alignment between all publications within and across the European institutions/agencies and should be ensured.

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

In addition to the reflections set out below we recommend referencing our input to the ECB guide on Climate and Environmental risks – see our key messages submitted to this consultation included in the Annex.

**Integration of ESG in pricing**

In considering the interaction between ESG risks and pricing of bank products, the EBA should take a holistic view of ESG risk management and incentives rather than focusing on just pricing. Indeed, risk adjusted pricing is already part of banks' approaches and should be left to individual firms.

Banks often use a number of risk management practises to manage ESG risks, whether it includes internal pricing mechanisms, risk appetite limits or requirements for risk reduction practises (e.g. CDS). This may or may not always translate into external pricing of products but should be examined holistically as part of a bank's approach to ESG risk management.

[1] See following AFME survey https://www.afme.eu/Portals/0/20200908%20AFME%20Survey%20Organisational%20set%20up%20of%20Sustainable%20Finance.pdf?ver=2020-09-09-143608-383&utm_campaign=1978678_Sustainable%20Finance%20Report%20and%20Survey&utm_medium=email&utm_source=Association%20for%20Financial%20Markets%20in%20Europe&dm_t=0,0,0,0,0

Furthermore, we would note that low ESG performers can be penalized for poor performance via regulation, fines, taxes set by governments. Banks can accompany and will complement EU policy, but they cannot substitute political action.

As stated in our response to the ECB climate and environment guide, changing the pricing strategy should be an option for banks but not a requirement. This has also been recognized in the final EBA GLs on Loan Origination and Monitoring. Based on existing guidelines and expectations, banks are supposed to take into account all material risks when defining risk-adjusted pricing policies. However, the final risk-adjusted pricing is the result of a holistic assessment which covers, among other things, the characteristics of the loan product and relevant contractual terms (i.e. duration, pre-payment features), riskiness of the borrower, prevailing market conditions (i.e. cost of funding and cost of capital) as well as strategic targeting and competitive position. ESG factors are drivers of existing risk categories, therefore will feed into banks' internal processes accordingly, when appropriate. Decoupling ESG factors, like any other element, would not only prove challenging from a technical standpoint but would also potentially interfere with business decision-making responsibilities.

However, if the EBA is to pursue a policy of requiring banks to adapt pricing strategy to account directly for ESG risks then this should reflect the maturity of the methodologies and analysis of ESG risks and supervisory expectations should phase in as industry and firm capabilities evolve. In particular, it should be recognized that the same constraints that apply to scenario analysis and inclusion of ESG risks into capital planning apply to loan pricing.

**Engaging with customers and other relevant stakeholders**

While we recognize that the dialogue with clients based on an internal ESG assessment can be an important tool to transition and transformation of economies in more sustainable systems (§180 & 181), the EBA should clarify that this should be done on a best effort basis by the lenders of the counterparty and focus in the first instance on customers in sectors that will be most challenged by ESG factors, as an application of the proportionality and materiality approach. Indeed, we see several shortcomings to systematic dialogue:

i) Due to the lack of reliable data in the short run, results of the analysis can be irrelevant for some counterparties.
ii) Large customers have recourse to different banks, which may have different assessments of the ESG risk due to the use of different tools developed in-house. The customers may not understand why some banks consider their ESG risks as ‘good’ while some others as ‘bad’. They may favour the bank with the highest ESG assessment on their own performance, which is an incentive for banks to develop soft assessments.
iii) Front Office needs to be trained on these aspects.

Banks could support their clients towards better ESG risks management (§184), however, it should be clarified how banks should advise “non-professional” customers, such as retail ones. This role could exceed the bank’s mandate and lead to reputational / liability risks.

The EBA also suggests in §223 for banks to enter into a constructive dialogue with critical counterparties, which narrows the range of counterparties with which to have a dialogue. We would welcome clarity from the EBA on what is meant by critical counterparties: are they the ones with the lowest ESG performances or the most significant in terms of exposures for the bank? Alternatively, this could be based on a mix of the two i.e. based on the most impactful counterparty if it were to fail as per the methodology used in stress testing.

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

**Utilization of pilot stress tests in the supervision process**

We welcome the recognition from the EBA that stress tests are run in pilot mode and are still too exploratory as exercises to trigger capital requirement consequences. We would note that stress tests can give very different results depending on the methodology used, the assumptions included, the time horizon and the scenarios which will be tested (smooth convergence, rapid convergence, no convergence). EBA should specify that their results should only be used, even qualitatively, by the regulators provided that they have defined a common set of assumptions and scenarios. This clarification should be a priority, as, per its guide on Climate risks, the ECB intents to start this dialogue this year. Having to design and implement assumptions and then readjust them to meet the "new" required framework will be counterproductive and inefficient.

**IT systems and data collection**

The EBA states (page 114) that institutions should be able to generate aggregate data efficiently on a timely basis to meet a broad range of on-demand requests. The EBA should clarify that this is expected from banks in the medium term. As long as the taxonomy remains incomplete, the NFRD is not in place, and stress tests exercises remain exploratory, then banks cannot develop complete databases that will enable "to meet a broad range of on-demand requests". Banks need to include the conclusions and main findings of all these exercises to see which data are most useful to be systematically included in the databases and then start building historical series.

The EBA has suggested that institutions collect ESG data from counterparties at the time of origination based on the requirements set out in the Guidelines on loan origination and monitoring. It less clear how the stock of exposure should be treated, and how to ensure the consistency of data calculation method (such as $CO_2$ emissions), driving their comparability and integration into new models. It would be useful if the EBA clarify this and we note the intention for the NFRD revision to help in this regard, but it is unsure to what extent the NFRD revision will be sufficient to make sure all needed datasets will be available to cover the existing stock - buying from vendors might be quite costly. In addition, the EBA should also recognise the proportionality principle included in the Guidelines on Loan Origination and Monitoring[2].

We also support a phase-in regarding data collection, ggiven the large spectrum of input banks can use, (quantitative data, qualitative approach, questionnaires (§232/237).

**Integration of ESG factors in modelling and capital planning**

While we welcome EBA comments on the difficulty to include ESG factors in internal credit models (PD, LGD) due to the lack of historical data including credit defaults due to ESG factors (§233), §325 requires that banks progressively test relevant ESG factors and include them in the credit models when they become statistically significant. We would note that credit models will always lag behind credit events. Overall, we think any policy recommendations on this should be purely qualitative at this stage. It is important for global approaches to be developed in this area and note that Basel is due to consult later this year.

**Integration of ESG factors in modelling and liquidity planning**

ESG risks are medium/long term ones, while liquidity risk is mainly a short-term risk. As stated in our response to the ECB Climate and Environmental Risks consultation (see annex), we were not supportive of integrating specific climate risks variables in liquidity assessments. A proportionate and staggered approach to the ILAAP should therefore be taken.

**Financial Ratings**

It would be useful to understand if banks are expected to modify internal financial ratings by integrating ESG risks or if this should be captured through an additional rating that would take into account long term horizon. We note using both together would then highlight a credit decision (a few paragraphs look contrary in this regard on pages 68, 70, 105).

**Specialized lending and project financing**

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

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

The "Conclusions and policy recommendations" set out in page 100 of the DP includes a recommendation to "allocate the responsibility related to ESG risks to a member of the management body". We consider the

[2] See page 10 https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Guidelines/2020/Guidelines%20on%20loan%20origination%20and%20monitoring/884283/EBA%20GL%202020%2006%20Final%20Report%20on%20GL%20on%20loan%20origination%20and%20monitoring.pdf

management body (board of directors) is a unique and inseparable body with collective responsibility, through which both management and supervisory functions are performed. All the members of the Board imperatively perform all the functions assigned to it as they are all, collectively, part of the decision-making process, and they all have the same rights and responsibilities; they are all under the same liability regime and should act as one single collegial body. For this reason we consider the recommendation set out should be deleted.

Additionally, it includes a recommendation to consider ESG risk in the advisory role of risk committees or creating specialised committees such as sustainability committees proportionate to the size, complexity and business model of the institutions. We welcome the clarity provided at the public hearing on 26th November that there is not one solution to incorporate ESG into the committees, either a special committee or an existing one ensures the appropriate attention and integration of ESG risks into the overall risk management framework. It is important that institutions maintain their flexibility, and this is reflected in the final report. We would also suggest the EBA avoids using size as the driver for considering the proportionality principle, allowing banks to determine if creating a specific committee or using the existing ones fit better to their internal governance structure.

**Remuneration**

With reference to the proposals on remuneration, we agree that institutions that have set ESG related objectives or limits to ESG risks should reflect it in their incentive schemes, as part of wider business performance objectives, this should be done in a proportionate way and also take account of the premise that there should be no double counting where climate risks are considered part of existing risk and limits set on those. We note consideration of the characteristics of ESG objectives is possible to do in long-term incentive schemes, whereas it could prove to be more challenging in short-term incentive schemes. ESG objectives tend to be difficult to measure under a quantitative perspective, thus in order to measure their level of achievement, it could be useful to allow qualitative discretionary evaluations, based on objective evaluation drivers.

Furthermore, while it is important for all staff members to have general knowledge on ESG risks, we do not see the need for specialisation in this area. ESG objectives should be only where the staff member holds a specific ESG responsibility, rather than being general institution-wide objectives set for all the staff of the institution. For example, managers of commercial structures could be assigned ESG objectives related to the development and sale of green bonds and S-loans. Further examples of ESG objectives that could be used in incentive schemes are: so-called "impact" related objectives such as the contribution of the institution to the education of youngsters, assistance to businesses to support their growth, and the presence of the institution in relevant global indexes. In particular, we note not all Material Risk Takers staff will have a material and direct impact on an institution's ESG strategy. Therefore, remuneration policies should be linked to ESG related objectives only for senior management members directly responsible for ESG related topics and potentially for Material Risk Taker staff directly involved in ESG institution's strategy.

In relation to the conclusions and policy recommendations for internal governance, as well as the social factors listed in Table 6.A in Annex 1, we caution against the blurring of lines between the responsibilities of the Remuneration Committee and the wider Human Resources function. We recommend that Remuneration Committee obligations should remain separate from any requirements relating to recruitment, retention or training, for example when considering measures to address an institution's gender pay gap.

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

The framework proposed is aligned to the internal roadmap that the industry is following to integrate ESG risks into risk management framework, as well as the ECB supervisory expectations and the EBA guidelines on loan origination and monitoring.

As part of the Annex to this response we have included our key messages to the ECB which were considered as part of our response to their guide, nonetheless we believe it is important to flag the following points on the EBA proposal, which should be carefully considered, or additional clarity is needed:

- Methodologies to understand ESG risks – the paper currently allows flexibility to institutions regarding the methodology and metrics to use to assess ESG risks (see paragraph 234 of the Discussion Paper). While we support this open approach, we think it is important that the EBA clarifies whether they will be maintaining this flexibility over time or whether and when we should expect a more specific guidance regarding what methodologies to use once there is more clarity on the outcomes, time frames (for instance if the direction is to go beyond 10 years horizons, methodologies with shorter horizons will be automatically excluded).
- Stress testing: We welcome the acknowledgment in the paper that stress test methodologies and approaches are in early stages.
  - We note however the reference on page 113 that the objective of a climate stress test should be to assess climate-related risks (…) "with a milder focus on capital implications". We think it is very important that the potential capital implications of these exercises are defined in a more precise manner. For instance, the EBA should define further what institutions should understand by "milder"; and spell out the elements/conditions that should be met so that their capital implications are to become more significant. The EBA should also specify how it will reconcile the differences in the time horizons (3-5 years for capital planning, >10-30 years for climate scenario analysis). Prudential capital aims to cover unexpected loss for 1 year, hence this is why capital is not appropriate at all to cover long term climate risks scenarios outcomes.
  - With regard to scenarios, we welcome the recommendation that institutions should leverage on the NGFS scenarios to overcome the modelling challenges on climate risk scenarios. However, it is important to bear in mind that banks need to cover a diversified portfolio with a lot of sectors/subsectors in different geographies. This granularity is incomplete at the moment, and it will take some time for the NGFS to be able to finalise the task. Similarly, we are concerned about the recommendation that intuitions should use "multiple scenarios" to assess climate risks. We think that this could add further uncertainty

and lead to heterogeneity in outcomes across institutions, as there is not for now a clear view on the climate pathways and year horizons etc. among other variables.

- We have some concerns around the level of ambition/expectation that the EBA set on the institutions' data infrastructure. At the moment, while data availability is an area of continuous progress, serious challenges prevail, and more are coming to light. We therefore believe that the EBA´s expectations on how feasible it is for institutions to have all the relevant data available to perform climate stress tests and respond to "a broad range of on-demand requests" could be too far reaching for now.
- We would encourage the EBA to properly reference the challenges around data, institutions dependencies´ on third parties including customers, data providers, etc, and acknowledge that as these are not standard tests, the same level of data consistency would be difficult to achieve at present. In addition, it is important to reiterate that we expect that the data quality and availability will gradually improve in the European Union as the reviewed NFRD and other initiatives are implemented, but this will not be the case in many of the jurisdictions where institutions operate. As an example, energy efficiency certificate requirements do not exist in many of the geographies where our members are located, nor are corporate customers required to publish emissions data under local laws.
- We would welcome more examples of S and G risks, in addition to those for climate risks for which banks have a better view and are already working on action plans for. Potentially further details could be provided using some of social and governance factors listed in an appendix, especially in relation to methodologies such as the portfolio alignment.
- Regarding the impact of market risks (§240), we would welcome clarity on whether the statement only concerns equity prices as well as more details regarding higher volatility and the correlation between this volatility and ESG factors. However, we believe market risk and liquidity should be assessed in a second stage, once the credit risks and liability/operational risks assessment is finalized. A phase-in approach/priority ladder should be appropriate for the risk categories.

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.

As the DP rightly points out, institutions´ and authorities´ approaches to environmental and particularly climate-related risks are slightly more advanced than approaches on social and governance risks (although it should be noted that challenges still remain significant, especially with regard to climate, physical and other environmental risks). In this sense, we would welcome confirmation from the EBA in its final report that the level of demand on the integration of social and governance risks will be less stringent at the early stage, until the approaches are more advanced. We note that the European Commission is currently consulting on the need to create a due diligence framework for companies to identify, assess and address potential or actual adverse impacts from business activity on ESG factors with a large focus on human rights. A legislative proposal is expected to be published in Q2 2021, and we would suggest that it is worth awaiting the outcome to support a coherent EU framework in relation to the S and G risk management for financial institutions. The EBA should also be mindful that management/governance factors are an integral component of credit risk assessments and ratings already such that any guidance from EBA is tailored at 'enhancing' without 'double counting' those factors. It would be helpful if the EBA could provide more clarity on the next steps or timeline by when it expects progress on governance and social risks.

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

ESG classified investments should be advised in line with the ESG profile of the Client in case of Advice or DPM (discretionary portfolio management).

**ESG factors and ESG risks in supervision (Chapter 7)**

***Integrating ESG risks into the SREP – the Associations' overarching considerations***

*Key highlights of the proposal*

According to the current EBA Guidelines and the ECB methodology, the SREP aims to produce an overall picture of an institution's risk profile that is as adequate as possible, taking into account all relevant risks and their possible mitigants.

The SREP assessment is performed based on a wide range of information sources of a quantitative and qualitative nature. Quantitative data are of particular importance for fostering consistency and comparability.

The SSM risk assessment system (RAS) supports the JSTs' day-to-day supervisory work. It is used for their ongoing analysis of Element 1 (business model), Element 2 (internal governance and risk management), Block 1 of Element 3 (risks to capital, covering all pillar 1 risks as well as pillar 2 risks), and Block 1 of Element 4 (risks to liquidity and funding). Supervisory assessments of the four elements and the overall SREP are formalized in a rationale and a score and the score leads to capital and liquidity requirements. Block 2 of Element 3 is covered by the ICAAP and Block 2 of Element 4 is covered by the ILAAP. Block 3 for both Element 3 and 4 is covered by stress testing.

While we understand Directive (EU) 2019/878 (CRD5) amending Directive 2013/36/EU (CRD4) mandates the EBA to assess the potential inclusion in all the elements of the SREP performed by competent authorities of environmental, social and governance risks (ESG risks) in the SREP and to report on its findings to the Commission, the European Parliament and to the Council by 28 June 2021, we call on the EBA to strike a good balance between "capturing institutions' risk profiles" and "avoiding unwarranted consequences" on the existing SREP scoring system which can rely on a stable methodology (previous EBA guidelines were released in 2018) and has served the ECB well so far. Especially when it comes to Element 3 (risks to capital) and Element 4 (risks to liquidity and funding), complementing existing indicators for the automatic scoring with ESG indicators needs to be thoroughly calibrated taking into account at least the following: i) information/data availability and ii) maturity of banks' internal methodologies.

While the review of the Non-Financial Reporting Directive (NFRD), can hopefully solve some of the issues associated with the existing "data gap", lack of robust internal methodologies will persist for quite some time.

Therefore, as an industry, we would like the EBA to consider a 2-tier phasing-in approach according to the table below. As an industry, we believe there are several reasons according to which such an approach is warranted:

- Competent Authorities will start factoring in 'E' in Business Model (Element 1) and Internal Governance and Risk Management (Element 2) already in 2022 SREP Cycle with potential supervisory actions applicable from 2023 (this timeline seems to be consistent with the EBA work plan, as discussed during the AFME – EBA call held in December 2020).
- Competent Authorities (and Supervised Entities alike) would be given ample time to fine-tune methodologies for Element 1 and Element 2 for 'S' and 'G' which are still at a very early stage compared to 'E'. This will also enhance the robustness and ultimately the credibility of the overall SREP.
- Risks to capital (Element 3) and risks to liquidity and funding (Element 4) would start at a later stage, in line with the other EBA mandate on 'the potential differentiated prudential treatment' of assets from a sustainability perspective (Final report due by 28 June 2025). This point is extremely important: we urge the EBA to align any possible pillar 2 framework around ESG to the pillar 1 framework to the aforementioned Report. An early introduction of a pillar 2 framework based on a pillar 1 framework due to the ESG would not only be potentially counterproductive, but also methodologically questionable. While we support the fact that E, S, and G are not standalone risks, but rather drivers of existing risk categories, we believe alignment between pillar 1 and pillar 2 frameworks is of utmost importance and the backbone of a reliable SREP methodology.

Finally, the overall timeline will be consistent with the recently agreed revised timeline for the finalization of Basel 3 (2028 as agreed at the BCBS in March 2020). Even though the EBA mandate on ESG does not arise from the Basel 3 standard, we believe that, given the magnitude of the change and the potential impacts associated with the incorporation of ESG factors into the SREP might have, strong alignment also with other important changes to the prudential rulebook is warranted.

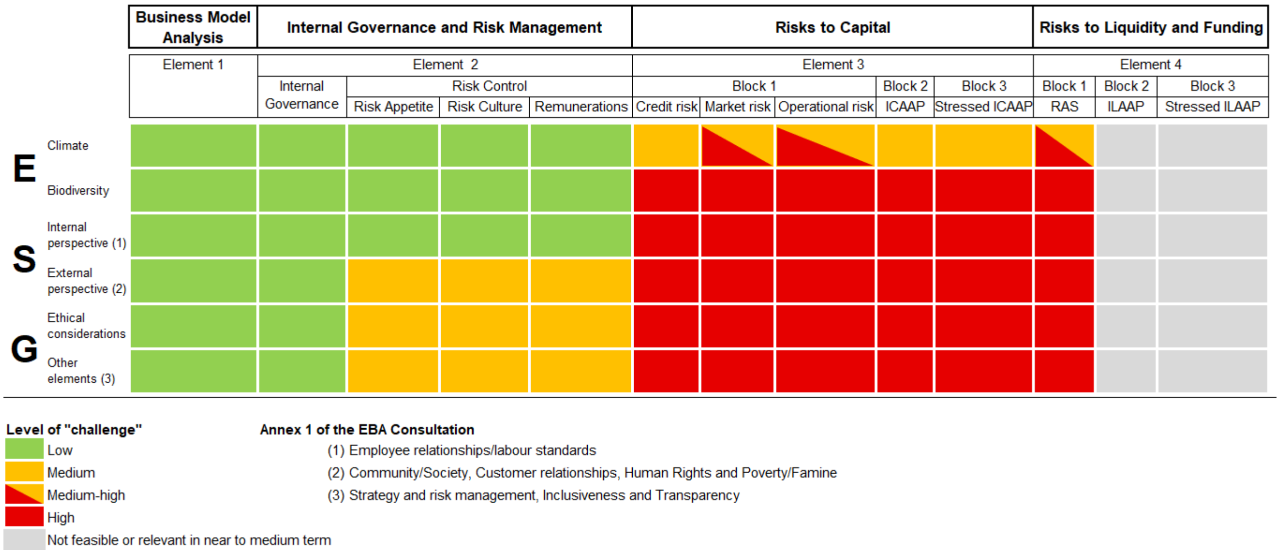
We see several advantages of introducing a phasing-in approach as outlined above, most notably:

- The flexibility of a "test & learn approach";
- Competent Authorities can calibrate SREP sub-scores more easily;
- Competent Authorities have time to tweak E, S and G without impacting the overall SREP methodology.

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

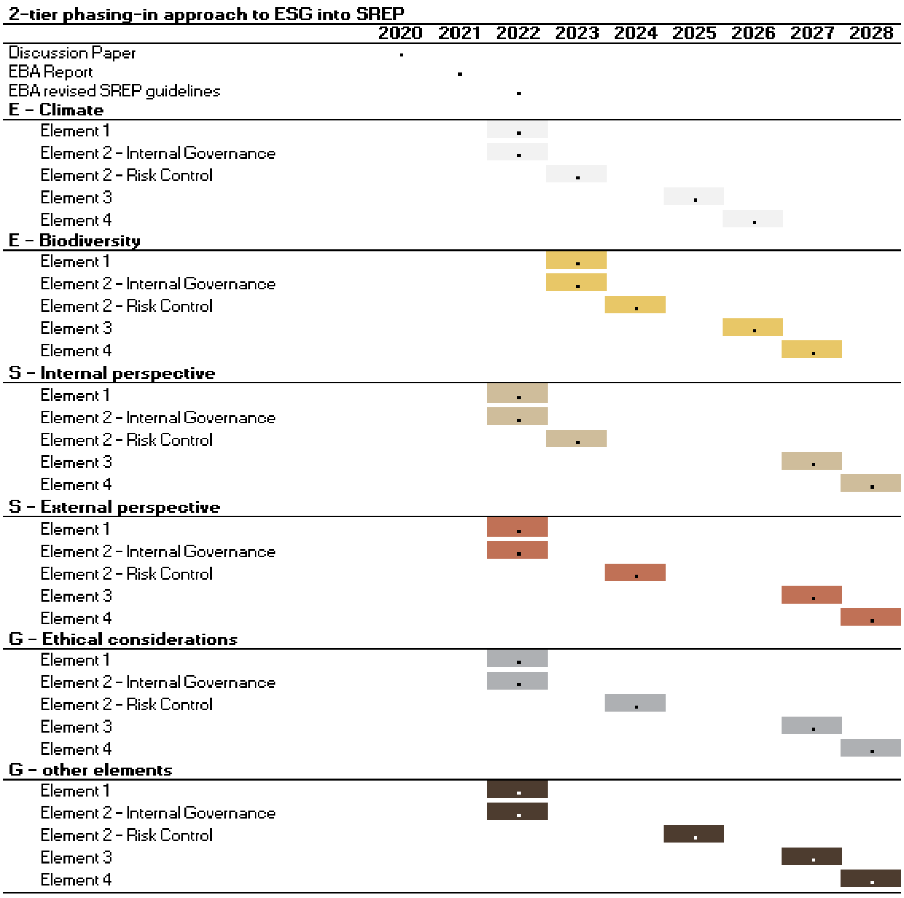
See overarching considerations, in addition we also set out a preliminary and illustrative heat map for the incorporation of ESG into SREP and the suggested timing below.

"Feasibility and relevance heat map" based on state-of-the-art supervisory methodologies:




Potential **timeframe** to integrate the E, S, and G into the SREP:

- Consistent with the "feasibility and relevance heat map" shown above, as an industry we would welcome a reasonable phasing-in approach which should strike the right balance between between "capturing institutions' risk profiles" and "avoiding unwarranted consequences";
- In the first review of the SREP guidelines (green boxes) incorporating E, S and G, we recommend including only Element 1 for all ESG scope and Element 2 only for climate and social internal perspective.
- As a second step (yellow boxes), Elements 2 could be enlarged to all ESG criteria.
- Concerning Element 3 for climate risks only, a preliminary minimised ICAAP approach without pillar 2 capital add-ons could be envisaged.
- Risk Control, Elements 3 and 4 for Biodiversity, S and G should not be part of SREP until the preceding steps and approaches have been well established.
- Element 4 (grey boxes) for E (both Climate and Biodiversity) seems far-reaching in the near to medium term.
- As an industry, we stand ready to further liaise with the EBA to provide our constructive views. More information on the phasing in is also to be found in the timeline below.




23. Do you agree with the need to extend the time horizon of the supervisory assessment of the business model and introduce as a new area of analysis the assessment of the long-term resilience of credit institutions in accordance with relevant public policies? Please explain why.

We would also note that in the assessment long term resilience of credit institutions, it is important to consider the value of geographic and sectoral diversification. Some studies suggest that bank lending has remained reasonably resilient in the face of past natural disasters, at least where banks' exposures are relatively diversified across geographic regions. The cross-border transmission of climate-related risks via financial institutions could give rise to diversification, by transferring risks to those best placed to bear them globally. Cross-border bank lending might therefore play a role in diversifying, rather than amplifying, climate-related risks across a range of lending countries.

See also our overarching considerations.

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.

Banks have already started to incorporate ESG risk considerations in their internal governance and wide controls ahead of regulatory requirements. Further incorporation of ESG risk considerations should be carried out following a homogenous approach embedded in existing standards and guidelines. This should be implemented in a proportionate way progressively over time. The EBA's final report will be central to this in establishing the definition of the ESG Risks, as well as a practicable calendar, since not all of the expectations and considerations in the activities and key processes (such, as an example ICAAP, ILAAP or stress testing) can be achieved at the same time. In this respect we welcome the EBA consideration of risk management of social and governance risk in section 7.5.5 ("In the medium term, however, it is reasonable to expect that both credit institutions and supervisors will have accumulated enough experience on the topic to be able to incorporate in a proportionate manner all ESG risks in their risk identification, measurement, monitoring and reporting frameworks.").

The role expected for the Risk Management Function and for the Internal Audit require a full definition of the ESG Risk, prior to adapting the internal regulation and/or defining skills or assigning roles and responsibilities in a 3 LoD Model approach. Likewise, the embeddedness of the ESG risk in the aforementioned key processes will require a clear definition, with common standards and indicators for their management and control.

See also overarching considerations.

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

The inclusion of these risks in the SREP process should focus on qualitative aspects and seek a "supervisor-supervised" dialogue/mutual learning in the first instance, before taking a quantitative approach. The supervisor should be very cautious in determining increases in P2R and P2G arising from ESG as recognised in §124 which recognises that quantification of capital requirements in climate stress tests is complex.

In line with our overarching comments, database strengthening will be critical in order to incorporate ESG risks into the assessment of capital, liquidity and funding, as it will be the basis for measuring the existing prudential risks.

With respect to the discussion paper, it approaches ESG risks to liquidity along three axes: (i) Short-term, (ii) Long-Term and (iii) Governance/risk management framework:

**Short- and medium-term liquidity risks:**

When considered on a "stand alone" basis, ESG risks are extremely unlikely to cause buffer depletions that are even close to those resulting from severe liquidity stress tests of idiosyncratic/market-wide nature run by the entities. ESG risks have mainly indirect impacts on liquidity, whereas existing liquidity stresses are focused on stressing "direct" liquidity risk drivers. In this sense, "stand alone" evaluation or ESG risks to short term liquidity does not add significant value or modify buffer calibrations, despite the high burden it may incur to undertake.

In case of a ESG risks occurring in conjunction with idiosyncratic/market wide liquidity stress, EU banks are currently running combined scenarios in liquidity stress tests which are considered market-wide risks (that may come from a ESG risk) and an idiosyncratic liquidity stress event. Nevertheless, the plausibility of such "specific double stress" scenario should be assessed by individual entities in light of their specific business models, the markets in which they operate and the capital impacts that specific ESG risks may cause to them. Conversely, ESG risks uncorrelated to idiosyncratic/market-wide liquidity risk drivers should be disregarded for liquidity adequacy purposes, given that they imply a remote/implausible "tail-tail" risk. As noted in previous answers (e.g. Q22) we do not think liquidity should be a priority area of focus in the near term.

**Long term liquidity risks (funding):**

We support the approach in the discussion paper to potential impacts on funding. We consider that ESG risks to funding should be assessed in financial/funding plans, in terms of funding stability and market access, especially in relation to the ESG strategy and positioning of the entity. This assessment should focus more on qualitative than quantitative assessment.

**Governance and risk management framework:**

We support incorporation of ESG risks in the different aspects of governance and risk management mentioned in the document, to the extent they reflect on those points raised above: liquidity strategy and risk tolerance, risk identification, stress testing, contingency plans and funding plans.

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.

Linked to the responses to Q22 and Q25, it is very important that the supervisor considers the different degree of maturity of the labour, human rights and environmental legislation and standards of the geographies in which financial institutions operate. The consideration of ESG risks in the SREP should not reduce the financing possibilities for developing countries' economies in which some financial institutions operate, put these institutions at a disadvantage compared to local entities or unsupervised entities, or hinder the diversification of European banks.

As raised on question 15, we welcome the inclusion of proportionality principle at certain points of the discussion paper, however we are concerned about the link made between the proportionality principle and the size of institutions in specific paragraphs across the discussion paper.

We think that automatically signalling size as the driver for assessing proportionality should be avoided. Assuming that large or smaller banks are more or less vulnerable to ESG risks simply because of size is not accurate. It is important that other criteria are taken into account such as business model, geographical location.

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 agree with the EBA's considerations.

**Annex 1**

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

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.

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**About AFME**

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

**About ISDA**

Since 1985, the International Swaps and Derivatives Association has worked to make the global derivatives markets safer and more efficient. ISDA's pioneering work in developing the ISDA Master Agreement and a wide range of related documentation materials, and in ensuring the enforceability of their netting and collateral provisions, has helped to significantly reduce credit and legal risk. The Association has been a leader in promoting sound risk management practices and processes and engages constructively with policymakers and legislators around the world to advance the understanding and treatment of derivatives as a risk management tool. ISDA has over 900 member institutions from 71 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. ISDA is listed on the EU Register of Interest Representatives, registration number 46643241096-93. Information about AFME and its activities is available on the Association's website: www.isda.org.

**Annex – the associations key messages in response to the Consultation on the ECB guide on climate and environmental risks (submitted 25 September 2020**

**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[3] 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)

[3] 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.

**(iv)** the geographical presence of banks and the varying maturity of countries regarding climate risk (e.g. different de-carbonisation targets in different jurisdictions).

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 baseline 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.**