European Leveraged Finance Association

BRIEFINGS

Summary Report

11 January 2021

Summary Document: EBA launches consultation to incorporate ESG risks into the governance, risk management and supervision of credit institutions and investment firms

Background

The European Banking Authority (EBA) published a Discussion Paper on Environmental, Social and Governance (ESG) risks management and supervision aiming to collect feedback for the preparation of its final report on the topic. The Discussion Paper provides a comprehensive proposal on how ESG factors and ESG risks could be included in the regulatory and supervisory framework for credit institutions and investment firms (hereafter “institutions”). The consultation runs until **3 February 2021**.

The main purpose of this discussion paper is to define and develop assessment criteria for ESG factors that may impact the financial performance and solvency of institutions via their counterparties. This paper:

- identifies for the first time common definitions of ESG risks, building on the EU taxonomy, and provides an overview of current evaluation methods; and
- outlines recommendations for the incorporation of ESG risks into business strategies, governance and risk management as well as supervision.

Article 98(8) CRDV and Article 35 Investment Firms Directive (IFD) mandate the EBA to develop a report assessing the potential inclusion of ESG risks in the review and evaluation performed by competent authorities and elaborating on the arrangements, processes, mechanisms and strategies to be implemented by institutions to identify, assess and manage ESG risks. The purpose of this discussion paper is, firstly, to present the EBA’s understanding on the relevance of ESG risks for a sound functioning of the financial sector and, secondly, to collect comments and feedback from stakeholders with a view to further informing the EBA’s report. The report is expected to be delivered in June 2021.

The reasoning and arguments presented in this discussion paper can be applicable to investment firms that are similar to credit institutions in terms of their business models and risk profile, and that fall under the framework of CRR and CRD. Those investment firms carry characteristics of credit institutions and may be subject to ESG risks in a similar manner. For other investment firms that may be different from credit institutions in terms of their economic activities because they do not have large portfolios of retail and corporate loans, the materialisation of ESG risks would manifest in different risk metrics monitored under the IFD.

Common Definitions: ESG Factors, ESG Risks and Materiality

This Discussion Paper includes proposals for common definitions of ESG factors and ESG risks:

- ESG Factors: environmental, social or governance characteristics that may have a positive or negative impact on the financial performance or solvency of an entity, sovereign or individual. Annex 1 of the Discussion Paper contains a non-exhaustive list of ESG factors, indicators and metrics.
- ESG risks: defined from a prudential perspective, in the context of the supervisory review, as the negative materialisation of ESG factors. ESG risks materialise when the ESG factors affecting institutions’ counterparties have a negative impact on the financial performance or solvency of such institutions. 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 of their investment activities in general.

Materiality of ESG Risks

According to the Discussion Paper, the materiality of ESG risks depends on the risks posed by ESG factors over the short, medium and long-term. In this regard, a double materiality perspective in terms of the impact that the counterparty's activities can have on the institutions' performance can be identified and includes both:

a. financial materiality, which may arise from such economic and financial activities throughout their entire value chain, both upstream and downstream, affecting the value (returns) of such activities and therefore typically of most interest to institutions; and
b. environmental and social materiality, stemming from the external impact of those economic and financial activities, typically of most interest to citizens, consumers, employees, business partners, civil society organisations and communities.

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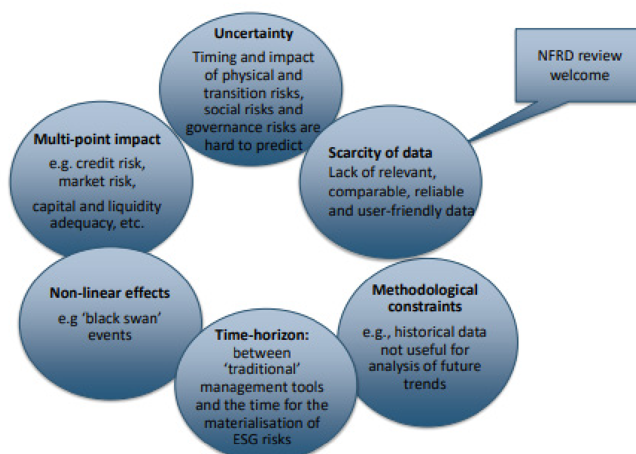
The EBA explains that, while ESG risks materialise through their impact on prudential risk categories, it is important that institutions and supervisors are able to distinguish and form a view on the relevance of ESG risks. Like in any risk assessment, a risk-based approach that takes into account the likelihood and the severity of the materialisation of ESG risks should be followed. The materiality of ESG risks will depend on the ESG characteristics of the different exposures, since not all financing activities are likely to be equally affected by them.

Assessing ESG Risks

The EBA provides that, in order to address ESG risks in a consistent way, it is essential not only to agree on common definitions of ESG factors and ESG risks but also on the qualitative and quantitative indicators and methodological tools to assess their financial impact. Commonly agreed ESG indicators and methods are important to support the incorporation of sustainability-related aspects into financial decision-making and supervision as well as to ensure a level-playing field, prevent the risks of 'green washing' and enhance transparency, customer protection and disclosures.

According to the EBA, there are a number of challenges for the integration of ESG risks in the institutions' management processes as well as into their supervision. Those most often cited include (please see the **figure below** provided by the EBA):



The EBA presents specific aspects relevant for the assessment by institutions and supervisors of ESG risks, namely:

1. Identification: This implies classifying assets according to their ESG characteristics in order to support the identification of ESG risks based on specific qualitative and quantitative indicators. This classification process allows to identify the main potential drivers of ESG risks, consistent with the significance of the different ESG characteristics, which then justify a more granular analysis on the most relevant categories (e.g. a given geography, sector), if needed.
2. Evaluation: Once exposures have been classified, methodological tools would need to be applied and possibly combined to assess the potential impact of ESG risks on the institution's 'portfolios'. Given that methodologies to quantify ESG risks are evolving, a dynamic, flexible approach would be needed.
3. Action: The natural outcome of the assessment of ESG risks would be a deeper understanding of the financial vulnerability of the institution to ESG risks. This would support the incorporation of ESG risks into risk management, through the adoption of a business strategy and risk management approach that supports the monitoring and control of ESG risks, including sustainability targets and limits as well as changes to the organisational setup of the institution, when appropriate.

Quantitative and Qualitative Indicators for the Identification of ESG Risks

The EBA provides that increasing efforts have been made to develop indicators that help to classify exposures and capture ESG risks in one way or another. The use of ESG indicators has been supported by the development of taxonomies and standards/principles. At the European level, the European Commission's 'Guidelines on non-financial reporting: Supplement on reporting climate-related information', which integrate the recommendations of the Financial Stability Board's Taskforce on Climate-Related Financial Disclosures (TCFD), provide a starting point for some climate-related indicators. Moreover, the EU Taxonomy Regulation classifies environmentally sustainable economic activities based on uniform criteria. Further, the European Commission adopted new rules setting out minimum technical requirements for the methodology of EU climate benchmarks. The new rules increase the level of transparency and comparability on the products developed by benchmark administrators, including the criteria for the benchmarks to be labelled as EU Climate Transition Benchmark or EU Paris-aligned Benchmark. Other ESG indicators are based on standards that provide certain, generally well accepted, measures or norms that allow comparative evaluations.

Methodological Approaches for Assessing and Evaluating ESG Risks

While providing the starting point for the identification of ESG risk, taxonomies and indicators by themselves are not sufficient for the estimation and evaluation of ESG risks, according to the EBA. Various methods exist for using and translating them into an assessment of ESG risks. Ultimately, all approaches have the same objective of assessing the alignment of institutions' portfolios with global sustainability goals and offering insights into the risk caused by exposures to certain sectors (for example, to climate relevant sectors). The decision on which methodological approach to choose will also depend on the size, the complexity and the business model of the respective institution and consequently the approach taken by a small, non-complex institution will likely differ from the one taken by a large institution. The EBA divides the methods for assessing ESG risks into three different types of approaches:

a. Portfolio alignment method
b. Risk framework method (including climate-stress test)
c. Exposure method

The Discussion Paper describes each approach in turn and provides some examples that are already applied in practice. The EBA explains that two elements are crucial in order for institutions to be able to assess and manage ESG risk and align risk management with sustainability considerations: 1) Factors considered and decisions taken at the time of exposure origination; and 2) Observations made and subsequent decisions taken during the monitoring of existing portfolios. All three methods described above lend themselves to loan origination and existing portfolio monitoring, albeit to varying degrees. In this Discussion Paper, the EBA explores how each approach may be used in exposure origination versus portfolio monitoring.

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Management of ESG Risks by Institutions

Further, the EBA addresses how institutions can embed ESG risks in their governance and risk management. The discussion is structured around the three main elements where the incorporation of the ESG risks is seen as essential:

1) business strategies and business processes,
2) internal governance, and
3) risk management

During this discussion, the EBA also identifies some of the main areas, where further progress is needed for a deeper understanding and measurement of the institutions' exposures to ESG risks, that can support the provision of more wide-ranging and comparable disclosures. The measures identified and the recommendations made are subject to the principle of proportionality, meaning that they are to be applied in a manner that is appropriate, taking into account in particular the institution's business model, size, internal organisation and nature and complexity of its activities. Below are some of the recommendations made by the EBA.

Business strategies and business processes

- The EBA sees the need for enhancing the incorporation of ESG risks into the institutions' business strategies and business processes. Adjusting the business strategy of an institution to incorporate ESG risks as drivers of prudential risks can be considered as a progressive risk management tool to mitigate the potential impact of ESG risk, in particular by:
  - ✓incorporating ESG risk-related considerations in setting business strategies by institutions;
  - ✓setting and disclosing specific ESG risk-related strategic objectives and/or limits by institutions, including related key performance indicators;
  - ✓assessing the potential need to develop sustainable products or to adjust features of existing products by institutions in alignment with their strategic objectives and/or limits; and
  - ✓adjusting the institution's relevant business processes to reflect its ESG risk-related strategic objectives and/or limits in the engagement with borrowers, investee companies and other stakeholders in order to lower the ESG risks associated with those exposures.
- The EBA recommends incorporating ESG risk-related considerations in directives and regulations applicable to the banking sector (e.g. CRD and CRR). In particular, the provisions on governance and risk management should be extended by the introduction of requirements to establish and implement long-term resilient business strategies, and the incorporation of ESG risks into the requirements on risk management. Such provisions would contribute to a better strategic management of the short, medium and long-term potential impact of ESG risks.

Internal governance

- The EBA sees a need for institutions to proportionately incorporate ESG risks in their internal governance arrangements. This should cover the management body and its 'tone at the top', allocation of tasks and responsibilities related to ESG risks as drivers of prudential risk categories in the decision-making process, adequate internal capabilities and arrangements for effective management of ESG risks, and remuneration policies that are aligned with long-term interests, business strategy, objectives and values of the institution.
- The EBA recommends institutions to achieve this by:
  - ✓considering ESG risks in the advisory role of risk committees or creating specialised committees such as sustainability finance committees or ethics committees, functions or working groups at different level;
  - ✓ensuring that the relevant committees or working groups meet regularly to follow up on implications from an ESG risks perspective;
  - ✓involving the risk management function at an early stage when integrating ESG risks into the risk appetite of the institution;

✓ensuring that the internal audit function includes ESG risks in its review of the effectiveness and adequacy of the internal governance arrangements, processes and mechanisms;
✓for institutions that have set ESG risks-related objectives and/or limits, considering implementing a remuneration policy that links the variable remuneration to the successful achievement of those objectives, while ensuring that green-washing and excessive risk-taking practices are avoided; and
✓establishing a framework to mitigate and manage conflict of interest which incentivise, short-term-oriented undue ESG-related risk-taking, including green-washing, misselling of products.

Risk management framework

- The EBA believes that, it is important for institutions to incorporate ESG risks in their risk management framework, including origination and monitoring. Origination is the initial phase where institutions have the opportunity to collect the necessary information and data in relation to the ESG risks associated with the different elements of the transaction, e.g., the product itself, collateral or counterparty. The information and data collected at the initial evaluation phase would directly feed into the monitoring process. The same information and data would be used for risk management purposes throughout the lifecycle of the transactions and products, subject to necessary review and updates.
- The EBA recommends institutions to achieve this by:
  ✓Including, in the risk appetite framework, not only a description of the risk appetite, tolerance levels, thresholds and limits set for the identified material risks, but also describe how the risk indicators and limits are allocated within the group, different business lines and branches;
  ✓setting out appropriate policies and procedures as well as criteria for the assessment of the repayment capacity and creditworthiness of the counterparties taking ESG factors and ESG risks into account;
  ✓collecting necessary information and data related to ESG risks associated with the counterparties at the loan origination phase, and review and update this information throughout the lifecycle of the transaction, where needed;
  ✓developing risk monitoring metrics at exposure-, counterparty- and portfolio-level, and categorise them by their ESG characteristics and risk associated with these, subject to their size and complexity;
  ✓managing ESG risks as drivers of prudential risks within their current risk management frameworks, in a consistent manner with the risk appetite, and as reflected in both ICAAP and ILAAP frameworks, and recovery plans; and
  ✓when it is possible, calculating indicators such as volume of outstanding assets from counterparties particularly exposed to social and governance issues.

Other Risk management recommendations by the EBA (Stress testing for climate risk)

- The EBA sees a need to gradually develop methodologies and approaches to a climate risk stress test. The objective of a climate risk stress test should be to assess climate-related risks and inform on the resilience of institutions' own business model and investment strategies with a milder focus on capital implications.
- Concerning the scope and coverage, climate stress tests should mainly focus on transition and physical risk having regard to both the on- and off-balance-sheet assets and liabilities of an institution including relevant structured entities. In this regard, climate stress test should also consider the correlations between usual risk types (i.e. credit and market risk) and environmental risks, and identify the related transmission channels. In addition, for the long run, a forward-looking approach rather than a probabilistic one (based on historical data) should be employed to better assess climate-related risks and their evolution along time.
- The results of stress tests (quantitative and qualitative) should be used to determine the effectiveness of new and existing business strategies from an ESG risks perspective and the possible impact from transition and physical risk.
- Institutions should ensure that their data infrastructure is proportionate to their size, complexity, and risk and business profile, and allows for the performance of climate stress tests covering all material risks that the institution is exposed to. Moreover, institutions should be able to generate aggregate data efficiently on a timely basis to meet a broad range of on-demand requests.

- Finally, given the higher uncertainty over climate pathways and the length of the time horizon, using multiple scenarios, instead of one or two as done in supervisory stress testing, would help to perform a broader assessment of climate risks.

Investment firms-specific considerations

In the Discussion Paper, the EBA thoroughly examines the specific ESG risks for the different types of investment firms. The EBA explains that the key arguments on the need to incorporate the ESG risks into the business strategies and processes are valid also for the activities of investment firms. Also, the need to capture the ESG risks in the internal governance and risk management of investment firms, reflecting the specificities of their activities is equally valid. Therefore, the EBA makes the following recommendations:

- The EBA sees the need for enhancing the incorporation of ESG risks into the investment firms' business strategies and business processes. Adjusting the business strategy of an investment firm to incorporate ESG risks as drivers of prudential risks can be considered as a progressive risk management tool to mitigate the potential impact of ESG risks.
- The EBA sees a need for the investment firms to incorporate into their internal governance and risk management frameworks an evaluation of the relevance of ESG factors and ESG risks depending on the specific activities they provide. Depending on their assessment, the investment firms should reflect ESG risks in their governance and risk management arrangements in a proportionate manner.

ESG factors and ESG risks in Supervision

Finally, the Discussion Paper elaborates on how ESG risks could be reflected in supervisory review. The EBA makes the following recommendations:

- The EBA sees a need to proportionately incorporate the ESG factors and considerations into the business model analysis, in particular with regards to the analysis of the business environment, the current business model, the analysis of the strategy, and the assessment of the viability and sustainability of the business model. Key aspects to be considered in this regard include (sub-)sectoral and geographic concentrations, the (potential lack of) reflection of the credit institution on the impact of a changing business environment, internal capacity building, relationships with stakeholders and projected profitability and losses under an ESG risks perspective.
- The EBA concludes that the existing assessment under supervisory reviews might not sufficiently enable supervisors to understand the longer-term impact of ESG risks, its breadth and magnitude, on future financial positions and related long-term vulnerabilities. In this context, the EBA sees a need to introduce a new area of analysis in the supervisory assessment, evaluating whether institutions sufficiently test the long term resilience of the business model against the time horizon of the relevant public policies or broader transition trends, i.e. exceeding commonly used timeframes of 3-5 years or potentially even the ten year-horizon already applied in some jurisdictions.
- The EBA is of the view that the supervisory review should proportionately incorporate ESG risk-specific considerations into the assessment of the credit institution's internal governance and wide controls, in particular how the ESG risks are incorporated into the overall internal governance framework, functioning of the management body, corporate and risk culture, remuneration policies and practices, internal control framework, risk management framework and information systems.
- The EBA provides that the impact of ESG risks materialises in the form of existing prudential risks (e.g. credit risk, market risk, operational risk). For this reason, the supervisory review should proportionately incorporate the ESG risks as drivers of financial risks, in particular risks to capital and risks to liquidity and funding. The assessment of ESG risks shall integrate and complement the already existing set of supervisory review, for both the assessment of the level of risk and the review of the risk-specific controls. The use of scenario analysis and stress testing is very relevant, particularly when assessing the resilience of credit institutions against specific scenarios.
- Finally, in order to facilitate the integration of the ESG risks into the supervisory framework, the EBA sees the need to implement the ESG risks definitions to legally and undoubtedly embed ESG risks under the scope of the supervisory review. In accordance with Article 16 of Regulation (EU) No 1093/2010, on the basis of the outcome of this discussion paper and as embedded in Article 98(8), the EBA can capture these risks in dedicated guidelines and, based on the recognised materiality of the ESG risks, these risks should be introduced in the CRD and IFD.

Important Information

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