Discussion Paper on management and supervision of ESG risks for credit institutions and investment firms

European Banking Authority (EBA)

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1 Introduction

Context and objective

In November 2020, the EBA published a discussion paper on the management and supervision of environmental, social and governance (ESG) risks for credit institutions and investment firms

As a consequence of the advance of climate change, in 2015 the EU decided to set the target of **reducing greenhouse gas emissions** by at least 40% – in comparison with 1990 – by 2030. Moreover, in 2019 the EU introduced the **European Green Deal** with the objective that Europe becomes a climate neutral continent by 2050.

The financial sector plays a fundamental role in financing the transition to a more sustainable economy. To reflect this role, the **Capital Requirements Capital Requirements Directive V (CRDV)** for credit institutions and the **Investment Firms Directive (IFD)** have been amended / drafted to include, amongst others, an EBA mandate to write a report that includes uniform definitions of environmental, social and governance (ESG) risks, as well as adequate qualitative and quantitative criteria (including stress testing and scenario analysis) for the assessment of the impact of ESG risks in the financial stability of institutions in the short, medium and long term.

In this context, in November 2020, the EBA published the **discussion paper on management and supervision of ESG risks**, which presents a proposal for how the ESG factors and risks could be included in the regulatory and supervisory framework of credit institutions and investment firms.

Main aspects of the discussion paper

- The discussion paper is mainly focused on the risks to which institutions are exposed through the impact of ESG factors on its counterparties.
- The paper is a step forward towards the compliance with the EBA mandates contained in article 98 paragraph 8 of the CRD V and article 35 of the IFD, with the aim of receiving information from the stakeholders about the proposed approach to integrate the ESG risks in the risk management of institutions and supervisory review.
- The paper is applicable to credit institutions and investment firms with business models and risk profiles similar to credit institutions, and which are covered by the Capital Requirements Regulation (CRR) and CRD.

This **Technical Note** summarizes the main aspects included in the discussion paper on management and supervision of ESG risks for credit institutions and investment firms.

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Executive Summary

DP structure

The EBA structures the DP around four key aspects: i) common definitions, ii) quantitative and qualitative indicators, metrics and methods to assess ESG risks, iii) Management of ESG risk and iv) ESG factors and risks supervision

This paper includes an analysis of the risks derived from **environmental factors**, especially those related to climate change, and covers on-going initiatives and the progress made in this area in the past years. Furthermore, it analyses **social and governance factors** in compliance with EBA mandates and raising the issues of why and how these factors may also be sources of risk for credit institutions and investment firms.

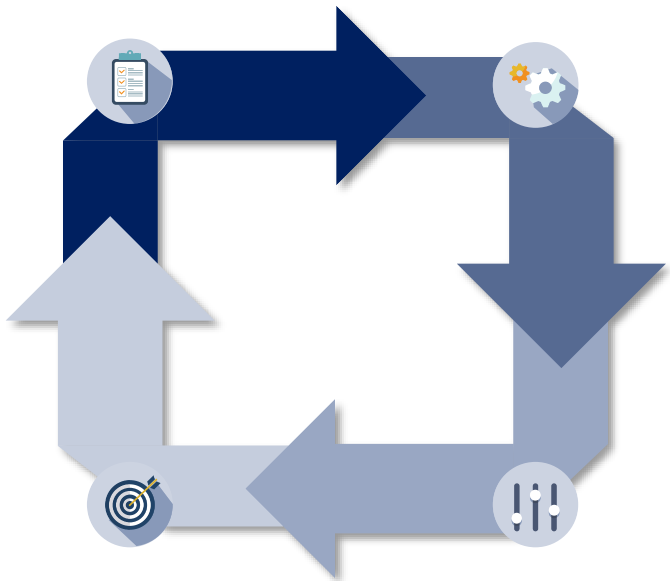
Common definitions

Definitions and clarifications in relation to:

- ESG factors
- ESG risks
- Transmission channels: physical, transition and liability risks

Quantitative and qualitative indicators, metrics and methods

- ESG metrics and indicators
- Tools and methodologies to assess, estimate and incorporate ESG risks (*Portfolio alignment,* risk framework methodology, exposure methodology)



ESG risks management

- Strategy and business processes
- Internal governance
- Risk management
- Specific considerations for investment firms

ESG factors and risks in supervision

- ESG factors such as financial risks drivers
- Extension of the time horizon in supervisory assessment (via scenario analysis / stress testing)
- Policy recommendations

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2 Executive Summary
Management of ESG risk

Legal provisions on governance and risk management may include requirements to establish and implement long term business strategies and include ESG risks, contributing to a better strategic management of the short, medium and long term impact of ESG risks

Axis	Main recommendations
Strategy and business processes	▪ The **EBA** considers that it is necessary to **improve the inclusion of ESG risks** in commercial strategies and processes of institutions. This adjustment may be considered a progressive risk management tool to mitigate potential impacts, in particular: ○ **Extending the time horizon for strategic planning, including environmental** and **social scenarios** into the planning process. ○ **Setting specific ESG risk-related strategic objectives and/or limits by institutions**, including key performance indicators (KPI), in accordance with it's risk appetite. ○ Assessing the need to develop **sustainable products** or to **adjust features of existing products.** Ideally, these would be aligned with **available standards and labels**, notably the EU Taxonomy Regulation and the EU Green Bond Standard or other relevant standards. ○ **Adjusting the institution's business processes** to reflect its ESG risk-related **strategic objectives** and relationship with stakeholders. ▪ The **EBA** recommends to **incorporate ESG risk-related considerations** in **directives** and **regulations** applicable to the banking sector (e.g. CRD and CRR).

The EBA considers necessary that institutions and investment firms proportionally include ESG risks in their internal governance mechanisms through the following practices

Axis	Main recommendations
Internal governance	▪ Consider **ESG risks in the advisory role of risk committees** or **creating specialised committees** such as sustainability finance committees or ethics committees. ▪ Ensure that the relevant committees or working groups **meet regularly to follow up** on implications from an ESG risks perspective (e.g. strategy, reputation and ESG compliance of counterparties) and **review** if there is an adverse impact. ▪ Justify the need for specialised committees and, where applicable, establish clear **work procedures and internal control functions**. ▪ **Allocate the responsibility** of ESG risks to a **member of the management body**. ▪ **Involve risk management function at an early stage** when integrating the ESG risks into the risk appetite. ▪ **Hire and train** employees, to improve specialised knowledge on how to identify, assess and manage risks. ▪ Ensure that management functions take ESG risks into consideration when applying **risk policies**. ▪ Ensure that the internal audit function includes these risks in its **review of the effectiveness and adequacy of its internal governance arrangements, processes and mechanisms**. ▪ Consider the possibility of implementing a **remuneration policy** that links the **variable** part to the achievement of the objectives, avoiding at the same time the “green-watching" and excessive risk taking.

It is important that institutions and investment firms include ESG risks in its risk management framework, including the origination and monitoring phases

Axis	Main recommendations
Risk management	The "origination" is the initial phase in which the entity **gathers relevant information and data** of the risks associated to, for example, the product, guarantee or counterparty. The information and data collected in the initial phase of the assessment **will be directly incorporated into the monitoring process** and used for risk management purposes throughout the life cycle of the operation. It is important that the entity achieves these objectives by means of: ▪ A **risk appetite framework** that includes its description, tolerance levels, thresholds and **limits for the identified material risks,** as well as a **description** of **how indicators and risk limits are assigned** across the group, business lines and subsidiaries. ▪ Definition of **policies and procedures**, as well as criteria for the assessment of the **repayment capacity**. ▪ **Collect counterparty information and data** in the origination phase of the loan and review and update this information throughout the lifecycle of the transaction. ▪ **Develop risk monitoring metrics** at exposure, counterparty and portfolio levels and **categorise** them according to their ESG characteristics and associated risks. ▪ **Manage ESG risks as drivers of prudential risks,** in accordance with the risk appetite and as reflected in the ICAAP and ILAAP frameworks and the recovery plans. ▪ When possible, **calculate indicators**, such as the volume of assets of the counterparty that are especially exposed to social and governance issues.

2 Executive Summary
ESG factors and risks in supervision

In order to reflect and assess ESG risks in the supervisory review, the EBA recommends to proportionally incorporate ESG factors in the analysis of the business model and the assessment of how the internal governance controls the alignment between the risk profile and business model

Axis	Main recommendations
Business model Analysis	▪ Mainly consider the **(sub)sector and geographic concentrations**, **environmental impact**, improvement of **internal capacity**, **relationship** with **stakeholders** and **projected profitability and losses**. ▪ The existing supervisory assessment does not allow supervisors to fully understand the long term consequences. Therefore, 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 its **business model** against the time horizon of the public policies or broader transition trends, i.e. if these exceed the commonly used terms of 3 to 5 years or even the 10 year horizon.
Internal governance and controls	The **supervisory review** should proportionally incorporate the considerations relative to 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**.

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Executive Summary

ESG factors and risks in supervision

The impact of ESG risks is materialized in the form of existing prudential risks: credit, market and operational risks

Axis	Main recommendations
Assessment of risks to capital	▪ **The supervisory review should proportionally incorporate 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 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. ▪ In order to facilitate the integration of ESG risks in the supervisory framework, the **EBA sees the need to implement the ESG risks definitions to** 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**.

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3 Key elements

Definitions of ESG factors and risks and transmission channels

The EBA defines the ESG factors as those environmental, social or governance characteristics, which may have a positive impact in the productivity of an entity

(1/3)

The majority of the frameworks and international standards do not provide a single and uniform definition of ESG factors. Nonetheless, taking into consideration the points in common between these, the EBA has identified intrinsic characteristics of ESG factors that may be interconnected:

Non-financial

In addition to those traditionally oriented to finance (e.g. capital), these reflect traits such as the greenhouse gas emissions or equality rights.

Uncertainty about the impact

These impacts may take place in different time horizons (short, medium and/or long term).

Negative economic externalities

Factors such as pollution reflect the impact of a sum of individual activities. Nonetheless, these are not captured in financial statements, which implies that the cost of such activities is borne by society at large.

Value chain patterns

Patterns derived from the activities with the stakeholders within the value chain (in a credit entity, debtors or creditors).

Sensitivity to changes in public policies

The signing parties of the SDG and Paris Agreement committed to reach the defined goals, which may imply changes in public policies and regulatory frameworks.

ManagementSolutions
Making things happen

ESG risks materialise when the ESG factors affecting institutions' counterparties have a negative impact on the financial performance or solvency of such institutions

(2/3)

Environmental risks

Environmental risks should be understood as the financial risks posed by the institutions' exposures to counterparties that may potentially contribute to or be affected by climate change and other forms of environmental degradation (such as air pollution, water pollution, scarcity of fresh water, land contamination, biodiversity loss and deforestation).

Physical risks

These are financial risks posed by the institutions' exposures to counterparties that may be negatively impacted by physical effects of climate change or other environmental factors, including:

- **Acute physical risks**: derived from certain events, specially related to climate such as storms or floods, which may damage production facilities and disrupt value chain.
- **Chronic physical risks**: derived from climate changes in the long term, such as temperature changes and rising sea levels.

Transition risks

Risks that generally refer to the uncertainty related to the timing and speed of the process of adjustment towards a low-carbon economy, including:

- **Policy** risks: e.g. as a result of the energy efficiency requirements of changes in the price of coal.
- **Legal** risks: e.g. litigation risk resulting from the lack of actions to avoid or reduce the impact on climate.
- **Technology** risks: e.g. technology with a less damaging impact on the climate replaces a technology that is more damaging to the climate.
- **Market** risks: e.g. consumer preferences shifting towards sustainable products.
- **Reputational** risks: e.g. difficulty to attract and retain clients if a company has reputation for damaging the climate.

ESG factors may influence the financial results of institutions, evidenced as financial and non-financial prudential risks

(3/3)

Social risks

Risks posed by the exposure of institutions to counterparties that may potentially be negatively affected by social factors, such labor relations or human rights.

Governance risks

Risks posed by the exposure of institutions to counterparties that may potentially be negatively affected by governance factors, such as a weak code of conduct or the lack of anti-money laundering measures.

Liability risks

Risks posed by the exposure of institutions to counterparties that may potentially be held accountable for the negatively impact through their activities on the environment, the society and their governance factors.

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3 Key elements

Quantitative and qualitative indicators, metrics and methods

ESG indicators and methods are important to support the integration of aspects related to sustainable decision-making and financial supervision

The inclusion of ESG risks in the management processes of institutions, as well as in their supervision, faces a series of challenges:

Uncertainty

It is difficult to predict the time and effects of physical and transition risks, social risks and governance risks.

Time horizon

Between the traditional management tools and the time for the materialisation of ESG risks.

Scarcity of data

Scarcity of relevant, comparable, reliable and user-friendly data.

Non-lineal effects

Specifically related to climate risks. When a climate risk event occurs, its impact is bigger both in terms of its initial impact and the impact over time. For instance, “black swan” events.

Methodological constraints

Historical data is not useful for the analysis of future trends.

Multi-point impact

For instance, credit and market risk, capital and liquidity adequacy, etc.

3 Key elements

Quantitative and qualitative indicators, metrics and methods

Special importance is given to the identification and assessment of ESG risks in the risk management framework, in accordance with the need to include these risks in the institutions' decision-making

The integration of ESG risks in the management process of institution's and as well as their supervision face several challenges:

Comprehensive approach to the assessment of ESG risks

Identification → Evaluation → Action

Identification

Classification of exposures according to ESG characteristics

Classify, for example, through the **categorization of exposures** across asset classes, sectors, counterparties, geographies, its length of maturity or position in the life cycle of the asset.

Evaluation

Estimation of ESG risks based on methodological tools

Apply methodological tools and combine them to assess the potential impact of ESG risks in the institution's 'portfolios'. Given that ESG risk quantification methods are in constant evolution, a dynamic and flexible approach is necessary.
The **main methods** are: **portfolio alignment, risk framework methodology, exposure methodology.**

Action

Inclusion of ESG risks

The outcome of the assessment of ESG risks is a deep understanding of the financial vulnerability of the institution to ESG risks. This contributes to the integration of ESG risks in risk management, through the adoption of a business strategy and risk management approach that supports the monitoring and control of ESG risks.

3 Key elements
Quantitative and qualitative indicators, metrics and methods

In the past years, new indicators that support the classification and identification of ESG risks have been developed, specially indicators related to the climate and environment as these are potentially easier to calculate and apply

The use of ESG indicators has been supported by the development of taxonomies, and standards/principles provided by third parties, such as international institutions, Non-Governmental Organisations (NGOs), rating agencies and data vendors.

Taxonomy

- Classify different elements within a specific set (e.g. economic activities, social practices or conventions), defining them and linking them to different categories based on certain criteria.
- The **EU Taxonomy** provides a starting point for the uniform identification and classification of economic activities, including activities for support and transition.

Standards

- Other ESG indicators are based on standards that provide certain measures or rules, generally widely accepted, and that allow **comparative evaluations**.
- The **International Organization for Standardization** (ISO) develops voluntary and consensus-based standards that are internationally recognised and that, following an independent validation and verification, provide accreditations to public and private organizations.

Certifications

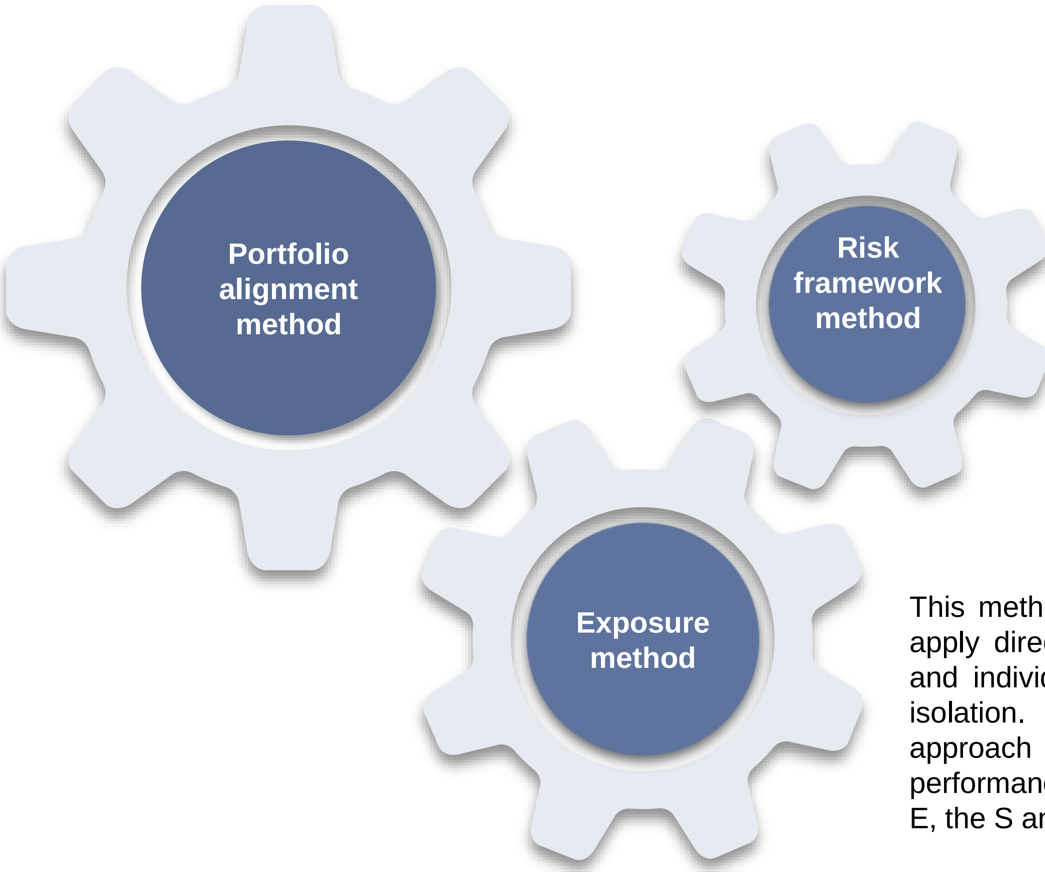
Compliance with the taxonomies and standards has supported the development of labels, which consist of certified accreditations that formally recognise compliance of financial products with given taxonomies and standards.

ESG indicators shall also include information about the transmission channels.

Providers specialised in assessing the characteristics of financial assets have also incorporated in their catalogues and products forward-looking, long-term investment benchmarks, which incorporate specific sustainability-related objectives and help to assess and compare over time the performance of sustainability-oriented investments.

The methods to assess ESG risks are divided into three different approaches: portfolio alignment method, risk framework method and exposure method

They key principle of this approach is for institutions, investors and supervisors to understand in how far portfolios are in line with **globally agreed** (climate) targets.



This approach is based on risk and focused on the sensitivity of the portfolios and the impact of climate change in the **actual risk exposure**.

This methodology is a tool that banks can apply directly to the assessment of clients and individual exposures, even in even in isolation. The basic principle of this approach is to directly evaluate the performance of an exposure in terms of the E, the S and the G.

3 Key elements

Quantitative and qualitative indicators, metrics and methods

The objective is that institutions, investment firms and supervisors understand to what extent the portfolios are aligned with the climate objectives agreed globally

Portfolio Alignment method

Risk framework methodology

Exposure methodology

It has a **results-oriented** focus. The approach examines the attributes of the portfolios and their contribution to sustainability and climate objectives, in particular the 2ºC target of the Paris Agreement. The results provide direct guidance on how far an institution would need to change its portfolio composition to align with the target.

- ***Pacta Tool***: tool developed by 2 Degrees Investing Initiative (2DII), which combines bank level portfolio information on client exposures, a database on the technology mix and production plans of individual companies and technology mix scenarios developed by the International Energy Agency (IEA) in order to assess an entity's alignment with the Paris Agreement Targets.

- ***UNEP FI's Principles for Responsible Banking****:* the objective is to align the business strategy of banks, with the objectives set out in both the SDG and Paris Agreement. It takes into account the three ESG components, not only the environmental component. It allows to map the exposures of participating banks (by type, country and sector) to the different areas of impact. The outcome is an overview for each bank in how far its exposures are positively or negatively affecting each impact area.
- **Methodology PCAF** (*Partnership for Carbon Accounting Financials*): tool to measure and disclose banks' direct and indirect emissions, based on a set of overarching accounting principles and covering nine different asset classes, from sovereign bonds to corporate and SME loan portfolios.

This approach is based on risk and focused on the sensitivity of the portfolios and the impact climate change has on exposures' actual riskiness

Portfolio Alignment

Risk framework methodology

Exposure methodology

It does not reflect the relationship between the portfolio composition and global climate objectives. Therefore, it does not provide explicit guidance on how banks should change their portfolios in order to align with ESG factors.

It is a tool that **allows** banks to **manage their risks internally and allocate their portfolios efficiently based on the existing risk**, taking into account climate risk.

The most developed risk framework methods in terms of climate risk are the following two approaches:

- ***Climate stress tests****:* usually performed in the form of **pilot exercises** due to the lack of experience and complexity of the design of climate stress tests. The **challenges** include the definition of hypotheses for the different climate scenarios; the uncertainty about climate evolution; environmental policies and the consequences for the financial and economic factors and how these are modelled; the accounting of technological changes and customer preferences; and data availability.
- ***Climate sensitivity analysis****:* **integrates climate risk in the financial risk indicators,** based on the classification of the exposures according to their positive or negative contributions to climate. This approach is simple and provides a clear idea of the relative productivity of the "green" vs. "non-green" exposures and the exposure of banks to sectors related to climate.

3 Key elements

Quantitative and qualitative indicators, metrics and methods

The basic principle of this approach is to directly evaluate the performance of an exposure in terms of ESG

Portfolio Alignment method

Risk framework method

Exposure method

The evaluation of ESG risk in the form of scorings or ratings **enables signalling to and dialogue with companies and clients**.

Several methodologies have been developed:

- ESG ratings provided by specialised rating agencies.
- ESG evaluations provided by credit rating agencies.
- ESG evaluation models developed by banks in-house for their own assessment.
- ESG scoring models developed by asset managers and data providers, publicly available.

3 Key elements

Quantitative and qualitative indicators, metrics and methods

The methodologies to assess ESG risks are split into three different approaches: portfolio alignment, risk framework methodology and exposure methodology

Methodology	Advantages	Disadvantages
Portfolio Alignment	• Introduces **explicit targets.** • **Direct guidance**, easy to execute. • **Results-oriented**. • **Aligned** portfolios are conducive to reduced reputational risk.	• It provides a **portfolio view** (it is not particularly focused on individual exposures, which may not be aligned). • It is **not focused on the individual dialogue** with the client (hence a potential obstacle to client transition). • Can be **complex** (in the case of the scenarios).
Risk framework method	• **Risk- based**: Looks directly at risk, hence integrates well with banks' 'way of doing things'. • The **dynamic nature** of the scenarios allows to reflect the interactions of sectors and variables, as well as climate dynamics.	• **Complex**, data issues, uncertainty, etc. • Linking the ESG risk to the actual financial risk indicators may be a "black box".
Exposure method	• Transparent, simple, can be done in isolation. • Established **methodology** (ESG ratings). • Links to key performance indicators (KPI). • Dialogue with firms.	• **Issues in the benchmark** of certain ratings. • The results are usually **qualitative.** • **Static nature –** ratings/scores shall be reviewed regularly.

Note: The examples provided are not exhaustive and shall not be understood as an indication of best practices or an EBA assessment to use certain methodologies in favour of others. The methodologies are listed in no particular order.

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The EBA structures the ESG risks management into three main elements: business strategies and processes, internal governance and risk management

Strategy and Business processes

- Monitoring the changing business environment and evaluating long-term resilience.
- Setting strategic objectives related to ESG risks.
- Engaging with customers and other important stakeholders.
- Considering the development of sustainable products.

Risk Management

- Risk appetite, policies and risk limits.
- Data and methodology.
- Remuneration.
- Risk monitoring and mitigation.
- Stress test for climate risks.
- Reporting and dissemination.

Internal Governance

- Management body and committees.
- Internal control framework.
- Remuneration Policy.

Monitoring the environment and long-term resilience and setting strategic goals improve the inclusion of ESG risks into institutions' business strategies and processes

Strategy and Business processes (1/2)

The EBA s**ees 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 risks.

Environmental monitoring and long-term resilience

- To include aspects related to the **definition of business strategies** in the planning processes of institutions, in particular:
    - **Extension of the time horizon** for strategic planning.
    - Using scenario analysis as the basis for the definition of strategies, **including social and environmental scenarios in the planning process** as to help institutions understand long-term trends in the business environment…

Strategic objectives

- **Setting specific ESG risk-related strategic objectives and/or limits by institutions,** including related key performance indicators, in accordance with the institution's risk appetite.
- Institutions may use the **Sustainable Development Objectives** to mitigate physical and transition risks.
- Strategic objectives and boundaries can also be formulated on the basis of the **EU Regulation on Taxonomy**. It is based on a classification system of economic activities that are considered ecologically sustainable.

The development of sustainable products and a greater collaboration with customers and other stakeholders positively contribute to the inclusion of ESG risks in the institutions' business strategies and processes

Strategy and Business processes (2/2)

Collaboration with customers and other stakeholders

- From an **internal perspective** and in relation to their customers, companies must **adjust their business processes to reflect their strategic objectives**.
- From an **external perspective, institutions should set strategic limits related to the engagement with borrowers, investee companies and other potential stakeholders** in order to mitigate ESG risks associated with those exposures.
- The EBA recommends **to incorporate the reflections concerning ESG risks into directives and regulations applicable to the banking sector (e.g. CRD and CRR)**. In particular, risk governance and risk management provisions should be expanded by introducing requirements for establishing and **implementing long-term resilient business strategies**, and incorporating ESG risks into **risk management requirements**.

Sustainable product development

- Assess whether **the strategy focuses on developing sustainable products** that are more resistant to ESG risks or whether the characteristics of existing products can be adjusted, aligning them with their strategic objectives and/or limits.
- This provides an opportunity for companies **to offer products and services that meet customer expectations and in turn tailor the portfolio**.
- In developing these products, companies will be **aligned with available standards and labels**, in particular with the **EU Taxonomy Regulation and the EU Green Bond Standard** or other relevant standards.

The EBA considers necessary that institutions incorporate, in a proportional manner, ESG risks into their internal governance arrangements

Internal Governance (1/2)

The EBA considers necessary for institutions to proportionally incorporate ESG risks in their internal governance arrangements. This includes the **governing body**, the allocation of **tasks and responsibilities** related to ESG risks as drivers of prudential risk categories in the decision-making process, the adequacy of **internal capabilities** and tools for effective management, and **remuneration policies** aligned with the long-term interests, **business** strategy, **objectives and values** of the institution.

Management body and committees

- The management body needs to **understand the potential impact of ESG factors and related ESG risks on their business model** and are responsible for **supervising and monitoring** that the company's **strategic objectives**, the **risk strategy** and proper **risk management** are achieved. For this reason, it shall:
    - Ensure that ESG risks are **considered in the role of risk committees or create specialised committees,** such as sustainable finance committees or ethics committees, functions or working groups at different levels, proportional to the size, complexity and business model of the company, ensuring their independence and resolving possible conflicts of interest.
    - Ensure that the committees or working groups **meet regularly to follow up on implications from an ESG risks perspective** (e.g. strategy, reputation and counterparty ESG compliance) and review whether there is any adverse impact, based on the limits set.
    - Justify the need for specialised committees and **establishing a clear procedures and mechanisms for the coordination between the specialised committees and other bodies** such as the Risk Committee or the Internal Control function.
    - There should also be a **person in charge of ESG risks within the organizations**.

Through tools such as the internal control framework and remuneration policy, ESG risks should be progressively incorporated into internal governance mechanisms

Internal Governance (2/2)

Internal control framework

- The management body is responsible **for implementing an appropriate internal control framework and for approving internal control policies, mechanisms and procedures.**
- Concerning the previous point, it is important to **integrate ESG risks into risk appetite at an early stage** and as a consequence involve the risk management function into this integration.
- **Recruiting and training** staff within the business units and internal control functions **to enhance expertise to identify, assess and manage ESG risks**.
- Ensure that the risk management functions **consider ESG risks when implementing risk policies** and that their controlling of the risk management framework also extends to ESG risks.
- Evaluating the extent to which **the role of the risk management function needs to be modified** for an adequate management of ESG risks.
- Finally, it is important that **the internal audit function includes ESG risks in its review of the effectiveness and adequacy** of internal governance arrangements, processes and mechanisms.

Remuneration

- It is important that **the remuneration policy is aligned with the ESG objectives of the company** to facilitate the achievement of these objectives, and that the workers would benefit from the achieving the long-term objectives.
- There is a need to establish **a framework to mitigate and manage conflicts of interest** that prevent undue risk-taking related to short-term ESG factors, including "green washing" and improper product sales.
- **ESG indicators should be taken into account and the long-term objectives** of the institutions should be taken into account in the design of remuneration policies and their implementation.

Active management of ESG risks is essential to ensure that institutions identify these risks in time and can therefore anticipate them

Risk Management (1/3)

It is important that institutions incorporate ESG risks into their risk management framework, including the origination phase and monitoring. In the initial phase, institutions have the opportunity **to collect the necessary information and data** regarding the ESG risks associated with the different elements of the transaction. This information and the data obtained will be used **for risk management purposes** throughout the life cycle of the transactions and products, subject to subsequent reviews and updates.

Risk appetite, policies and risk limits

- With regard to **risk strategy, risk appetite and the overall risk policy**, it is important to ensure that these reflect **ESG factors as part of the overall framework.** This would allow institutions to **regularly assess the risk profile** of their counterparties also from an ESG perspective and to integrate this approach into all relevant processes of the risk management framework.
- The **risk appetite framework should also include a description of how risk indicators and limits are assigned** within the banking group, individual business lines and branches.
- Appropriate **policies and procedures should be established, as well as criteria for the assessment of the repayment capacity and creditworthiness of counterparties**. With respect to physical risks, institutions may set limits to consider the potential physical impact of geographical events (e.g. floods and droughts on land).
- Depending on the overall strategy and approach to transition risk, **relevant limits may need to be reviewed or extended to new types of limits** relevant from an ESG perspective.
- ESG risks should be **managed as prudential risk drivers** within their existing risk management frameworks, and institutions should include in the ICAAP and ILAAP a description of the risk appetite levels, thresholds and limits set for the material risks identified.

The quality of information and the development of models that allow risks to be identified and measured are key aspects that mitigate the potential impact of ESG factors

Risk Management (2/3)

Data and methodology

- The **availability and accuracy** of data **is critical** to a sound risk management framework. The lack of data to identify and measure risks is one of the main challenges faced by institutions, and it is necessary **to collect this information during the lifetime of the transaction.**
- Data on ESG risks are necessary for large institutions to comply with the Pillar 3 disclosure requirements as per Article 449(a) of Regulation (EU) 2019/876.
- In **developing the methodology**, it is essential to assess which of the **existing methods can best incorporate ESG factors and risks,** and which additional methods or approaches should be incorporated to capture exposure-based and portfolio-based risk measurement and monitoring.
- Institutions should **develop risk monitoring measures** at the exposure, counterparty and portfolio level and categorise them according to their ESG characteristics and the risk associated with them, subject to their size and complexity.

Monitoring and risk mitigation

- **Proactive strategies and forward-looking approaches** to develop long-term resilient models, together with appropriate governance mechanisms, should be understood as tools that mitigate the potential impact of ESG risks.
- When **identifying and measuring** risks, institutions should use measurement methodologies that capture the most relevant ESG factors and address their uncertainty.
- Institutions can manage ESG risks, up to a certain level, by implementing a **policy of exclusion or by setting specific limits** for tailored ESG risk indicators.
- **Price** is another element that should **reflect the risks arising from ESG factors**, linking their **risk appetite to their pricing strategy.**
- ESG risks require **continuous monitoring**, using tools, models and data.

Climate stress tests remain less comprehensive than the usual stress tests and, given their complexity and assumptions, must be assessed and interpreted with caution

Risk Management (3/3)

Stress test for climate risks

- EBA considers necessary **to develop methodologies and approaches for climate risk stress test.** However, some of the principles in the EBA guidelines on stress testing (EBA/GL/2018/04) for institutions remain applicable and should be used as the main reference.
- Institutions should have a **climate risk stress programme** in place. To overcome the modelling challenges related to the climate risk scenario, institutions could take advantage of the reference scenarios provided by the international organization.
- The results of the stress tests (quantitative and qualitative) should be used **to determine the effectiveness of business strategies**.
- **The data infrastructure should be proportional to its size, complexity and risk and business profile**, and allow for climate stress tests to be carried out **covering all the material risks** to which it is exposed. In addition, they must be **capable of aggregating** data efficiently.
- In terms of **scope and coverage**, climate stress tests should mainly focus on **transition and physical risk**, taking into account assets and liabilities both on- and off-balance sheet:
    - It should **consider the correlations between the usual types of risk** (i.e. credit and market risk) and environmental risks, **and identify the related transmission channels**.
    - In the **long term**, **a forward-looking approach rather than a probabilistic one** (based on historical data) should be used to better assess climate-related risks and their evolution along time.
- 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 have very similar characteristics to banks and may therefore also be subject to ESG risks

Investment services firms

Given the importance of these risks, it is expected that investment firms will increasingly take factors into account in their activities and potentially adjust their investment behaviour to reflect their tolerance for ESG risks.

Key aspects

- Investment firms carry out a range of (mutually non-exclusive) investment services and activities. These services and activities are listed in **Annex I to Directive 2014/65/EU.**
- **The activity** of investment firms **is exposed to credit risk**, mainly in the form of counterparty risk, **as well as to market risk** from positions they take on their own account, whether or not related to the client.
- They have characteristics of banks and **may be subject to ESG risks** in a similar way. They are expected to consider ESG factors in their activities and to reflect their tolerance for ESG risks.

The EBA considers necessary that investment firms ...

- Improve the incorporation of ESG risks into their **business strategies and processes**. Adjusting an investment firm's business strategy to incorporate ESG risks as drivers of prudential risk can be seen as a progressive risk management tool to mitigate the potential impact of ESG risks.
- Incorporate into their internal governance and risk management frameworks **an assessment of the relevance of ESG factors and risks** based on their specific activities. Based on their assessment, they **should reflect ESG risks** in their risk governance and management arrangements in a proportionate manner.

Contents

The main ESG risks to be assessed are: ESG risks in the analysis of the business model, internal governance and controls of the entity, assessment of risks to capital and liquidity risk assessment.

01 Business model analysis

02 Internal governance and institution controls

03 Assessment of risks to capital

04 Liquidity risk assessment

ManagementSolutions
Making things happen

From the ESG risks perspective, the analysis of the business model involves an assessment of the long-term resilience of an entity, supported by a strategy based on sustainability

Business model analysis

- It is described how supervisors can integrate the ESG risks consideration in the business strategy as an **additional perspective** when analysing the institutions' business model.
- Competent authorities should consider, among others:
  - Relevant political commitments, such as the Paris Agreement or the European Green Agreement.
  - Social changes resulting, inter alia, from the COVID-19 pandemic and increasing digitalisation.
  - The economic effects of more frequent and severe natural disasters and increasing environmental degradation, technological advances and changes in customer preferences.
- In the analysis of the current business model, supervisors conduct both a **quantitative analysis**, to understand its financial performance and capital and liquidity adequacy, and a **qualitative analysis** to understand how the credit institutions' financial performance is driven by its risk appetite compared to peers and its potential success drivers and key dependencies. **In both analyses, the impacts of ESG factors and risks should be assessed**.
- The analysis of the business model should include: an analysis of the **business environment**, the current **commercial model**, the **strategy** analysis and the **assessment of the viability and sustainability** of the commercial model.
- The assessment of long-term resilience would be a new aspect of the monitoring assessment and **would go beyond the 3-year minimum time horizon** currently envisaged on the basis of the SREP 195 Guidelines and would also be in line with relevant policies, such as emission reduction targets set for 2030.
- It is very important for supervisors to understand that a **high level of strategic ambition in terms of ESG risk related objectives** (and/or limits) **is not necessarily equivalent to a high risk level of the strategy**.

3 Key elements
ESG factors and risks in supervision

The main objective of the supervisory assessment of the internal governance is to evaluate whether the institutions' arrangements are in line with the risk profile, business model, nature, size and complexity

Internal governance and controls of the institution

- It is examined **how ESG factors and risk management have been incorporated into the overall internal governance framework**, in particular: :
  - ESG-related strategies and policies in the organisational structure and responsibility of organisational units.
  - ESG related aspects of an institution's business and risk strategy, including the determination of its risk appetite.
  - ESG-related aspects in risk policies and their implementation.
- The **management body** plays a key role in addressing gaps in the credit institutions' business profile and strategy, including uncertainties about the impact of ESG risks on the institutions' business activities and the implications of the transition to a more sustainable economy for the institutions.
- In assessing the organisation and functioning of the management body, aspects of ESG risk are included such as:
  - Whether the management body in its **management function appropriately** directs the business considering the credit institution's ESG risk-related strategy.
  - Whether the supervisory function **adequately oversees and monitors the management decision-making and actions** taking into account the objectives and/or limits of the institution.
  - Whether the management body has sufficient **knowledge, skills and experience.**
- This section repeats the reference to issues discussed previously such as**: remuneration policies and practices**, the **internal control framework**, the **risk management framework** and **information systems**.

The impact of ESG risks materialises in the form of existing prudential risks: credit risk, market risk and operational risk

Assessment of risks to capital (1/3)

- A fundamental characteristic of ESG risks, and especially those related to climate and the environment, is their manifestation **not only in the short and medium term, but also in the long term**, in the following decades, because the physical impact of environmental change and/or because previously insufficient political action forces a sudden and comprehensive transition.

Credit, market and operational risks are examined.

- **Credit** risk**:** While credit risk is generally assessed in the short to medium term, the introduction of ESG controls in its assessment entails the need to enhance the extension of the horizon of the analysis through the use of forward looking metrics (e.g. scenario analysis).
- **Market** risk**:** Supervisors must assess the way credit institutions monitor the impact of ESG risks on their **market risk positions**.
- **Operational** risk**:** Supervisors may consider that the risks that institutions finance increase the future risk of reputational or legal damage.

While credit risk is generally assessed in the short to medium term, the introduction of ESG assessment in its analysis implies the need to extend the time horizon through forecasting measures

Risk assessment for capital (2/3)

Credit risk

ESG risks should be considered in the assessment of the **risk** profile of the **counterparty**. At portfolio level, ESG risks can be assessed by means of **concentration analysis** (considering both counterparties and collateral) and, through a **review of the specialised lending portfolio**.

Sectoral concentration can provide an overview of the exposure to transition risk when matched with transition risk metrics. This methodology has been largely explored in assessing how sectors are impacted by ESG risks.

At **geographical level**, supervisors might look at risk metrics matching the **location of counterparties** with the physical risks that these locations could face.

Specialised lending and project finance require a targeted focus. Institutions are likely to consider **using these products to finance projects with low ESG risk** of the counterparties more exposed to ESG risks.

Having **appropriate controls**, such as a list of projects and activities or the criteria that the institution considers eligible for environmentally sustainable loans, **could provide insights into the risk that institutions face when engaging in "greenwashing" activities**.

The result of such an analysis will not only serve to assess the credit control framework of credit institutions, but will also support the analysis of the related reputational risk.

Supervisors should assess how banks monitor the impact of ESG risks on their market risk positions

Risk assessment for capital (3/3)

Market risk

Investors and market participants show a **growing awareness of the importance of ESG risks.** Although the level of ESG issuances is still low compared to the size of the financial markets, demand for ESG investments is increasing.

When examining the market risk strategy, supervisors will find important information on how the credit institution responds to ESG risks in the financial market. The presence of **specific investment criteria**, including **ESG checklists** and the requirement on a proper **due diligence** on market investments, are positive signs of how much the credit institutions has engaged with the topic.

Operational Risk

In relation to operational risk, supervisors might consider that **failure to assess their positions under ESG standards** could result in future **financial damage** through **reputational or legal risks.**

Supervisors may examine whether the institution has recognised these risks and assessed them appropriately. Among other things, a signal of understanding of the risk might be the decision, by credit institutions, to **link their operational and business activities to ESG standards**, which provide a direction in which institutions can steer their business.

In this respect, specific attention shall be devoted to **liability risk**. Credit institutions that do not adequately assess the ESG profile of their products might be involved in future miss-selling claims, with the risk of financial impacts.

Banks consider the link between ESG risks and liquidity and funding to be more indirect, yet it is important to take them into account when assessing liquidity and funding risks

Liquidity risk assessment

- The short and medium-term **liquidity risk assesses whether the credit institution maintains adequate levels of liquidity buffers**, under both normal and stressed conditions. Under this assessment the ESG factors and ESG risks seem to be the most relevant to consider when conducting:
  - Evaluation of **liquidity needs** in the short and medium term.
  - Evaluation of **liquidity buffer** and **counterbalancing capacity**.
  - Supervisory liquidity **stress testing**.
- The third component in the assessment of risks to liquidity and funding is the **governance and risk management framework** underlying liquidity and funding risk. This includes elements such as the **liquidity risk strategy** and the liquidity risk **tolerance** or the institution's liquidity **contingency plans**.

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4 Next steps

- Comments on this document should be submitted by **3 February 2021.**
- The final report is expected to be published in **June 2021**.