POSITION PAPER

ESBG response to the EBA Consultation on the Discussion Paper on management and supervision of ESG risks for credit institutions and investment firms

ESBG (European Savings and Retail Banking Group)

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General remarks

- Overall, the EBA's non-prescriptive approach is welcomed. In particular, the chapter on definitions provides clarity on the implications of other supervisory papers that have already been published in advance of the EBA Discussion paper on management and supervision of ESG risks for credit institutions and investment firms (hereafter referred to as the discussion paper).
- Nevertheless, focusing on the EBA's final report we consider that more precision, clarification an in-depth discussion of some aspects covered in the discussion paper is still needed.
- Starting with the definitions some conceptual issues arise around the use of a common taxonomy "*ESG risks*" for referring to risks of different nature; moreover, there is still margin for more concretion as the definition of factors is based on examples which are not mutually exclusive for the different kind of factors (E, S & G) leading to confusion.
- The definition of factors is fundamental for the comprehension of the definition of risks and their implications for a sound management of banks.
- In relation to their taxonomy, from a risk management perspective, contrary to an investors' view, **we do not consider proper to cover in the same taxonomy risks of a very different nature**, despite their commonalities.
- The mixture of environmental, social and governance risks in the same taxonomy can cause misunderstandings, despite clarifications on the discussion paper. It seems that ESG risks are emerging at the same time, with the same path, having similar impacts, which can be approached with similar methodological tools.
- On the contrary, industry practices show that there are **very different needs about the timing of the inclusion of each one of these risks** and the assessment of their prudential materiality. The same is observed even within the same category of risks, for example on governance, (currently) having poor gender diversity in governance bodies doesn't have the same prudential output than lack of compliance and corruption.
- In this regard, whilst we believe that the current maturity of data availability and methodologies allows for a progressive inclusion of climate risks in the prudential framework of banks, this is not the case for other environmental, social and governance risks.
- The inclusion of any risk in the prudential scope should be considered from an adequate perspective. At this stage banks are hardly managing to obtain the required data from their clients to manage climate risk and there is no data available for other environmental risks nor for social and governance risks as well.
- In the future this can change when a greater advancement is reached on the gathering of standardized, reliable, and verified non-financial reporting information. The initiatives of the IFRS Foundation and EFRAG for the establishment of a global-European non-financial standard as well as the review of the NFRD by the Commission are very relevant.
- It is important to underline that **this does not mean that such risks are not treated at all already** in the banks' management, business strategy or even the prudential framework. Indeed, we consider that under the management of other financial and non-financial risks they are at least partially included (as risk drivers or such risks).
- It means that **they shall not be included as new independent category in the prudential framework**.

- We believe that **prudential regulation is fitted for purpose** regarding the procedures **for the assessment** and the inclusion on banks' risk management of **emerging material risks**.
- Modifications of legal acts to include specific risks should be promoted only in the case that their particularities require a specific treatment or that a gap is identified after a quantitative impact study is performed.
- For the risks analyzed in the discussion paper, at this stage **we do not identify a need of modifying the regulatory framework** to specifically include them as a new risk category. **Risks assessment processes** have demonstrated that they **work properly** to identify emerging risks as it has been the case for climate risk.
- **Risks** that are **not identified by banks as material** on their annual risks assessment processes **do not pose a first degree order/significant risk to banks' solvency**; as such those risks are **not included on banks' risks catalogues** and shall **not fall under the prudential scope**.
- The discussion paper clarifies in page 39 that it aims to discuss the management of ESG risks and not banks' own ESG factors. The restriction of the discussion of ESG risks to the counterparties of the institutions (customers, issuers) is consistent with the approach to climate risks and, as such, is welcomed although we think it requires and in-depth analysis.
- Despite the clarification, the discussion paper frequently mixes entities' approaches to ESG factors with such of their counterparties (ESG risks). As an example, the discussion of operational risks in chapter 7.5.4 is focused on entities' factors, not risks.. Consequently, a clarification is welcomed.
- The report also suffers from mixing general and partly academic considerations with concrete definitions and possible future requirements for credit institutions. In some cases, it is unclear what status and relevance the statements have.
- In this regard, a very relevant issue is that the discussion paper assumes that ESG risks pose a systemic risk to banks' solvency, but apart from providing punctual examples and theoretical presumptions it does not demonstrate its fundaments.
- Whilst available evidence and data reflect without doubt the **systemic risk that climate change poses** to the whole economy, and as such to banks, the financial system and banks' counterparties, this does **not seem to be currently the case for social and governance factors**.
- **Social and governance factors have gained a lot of relevance**, particularly in the investor ecosystems in recent years. More generally, the social interest for companies' social responsibility, integration of long-term objectives in corporate management and incorporation of other stakeholders' interest in companies' corporate governance is clearly growing.
- Nevertheless, this observation does **not automatically trigger systemic solvency implications for banks**. Indeed, any negative financial impact coming from social or governance risks, at the current stage, is of second or third order.
- The capital framework of banks due to the fundamentals of its design is ready to absorb eventual unexpected losses coming from social or governance risks and it will continue being fitted for purpose if these risks does not turn systemic.
- Additionally, the regular risk assessment exercises of banks guarantees timely identification of risks before they turn material.

- It shall also be noted that the current **credit risk assessment partially covers most relevant governance factors** for large corporations, which are the counterparties that could be more sensible to such factors (ex. external ratings incorporate an evaluation of governance structure and arrangements). This could be an indicator that SG risks are risks drivers not risks categories.
- Additionally, it should be **evaluated in-depth whether** at this stage **for banks' soundness it is more relevant their exposition to the impact of their own social and governance factors or the impact of the social and governance factors of their counterparties.**
- Currently, the relevance of the management of **reputational risk is key to banks**. Banks' commercial practices as well as social commitment and impacts are continuously exposed to the scrutiny of a wide set of stakeholders. This is an indicator of the relevance of their exposition to own social and governance factors.
- Through the management of reputational risk, banks also partially incorporate their preferences, in function of their business strategy and risk appetite, towards the tolerance to some social and governance risks of their counterparties. A clear example is the practice of some of our members to exclude from their financing some controversial sectors.
- The COVID-19 crisis has clearly demonstrated the relevance of the management of banks' social factors. Banks' support toward their clients in a wide set of actions was directly related to their approach to social factors whilst at the same time managing credit risk. This management has help to improve social perception of banks activity.
- As it is argued in the discussion paper, the COVID-19 will have implications on the medium to long term on companies' processes because of **structural changes** in the way of working, for example. Indeed, one of the most disrupting structural change in recent years is digital revolution. The speed of adaptation to and integration of such changes is crucial.
- Such impacts, with current available information, can hardly be isolated from the general management and business strategies of companies, something which is eventually reflected (as always been) on the credit quality analysis of companies (and as such, reflected at least partially on risks parameters).
- Some aspects of the management of operational risk can also be partially covering some social and governance factors.
- We observe that to a high degree **current banking processes and frameworks cover partially** some of the risks that can emerge from **social and governance risks from the counterparties** whilst at the same time managing own factors.
- We reiterate that with the current stage of available methodologies and processes, these social and governance risks can't be treated as a new and independent category. On the contrary, any attempt to do this would lead to substantial double counting of risks and won't be justified since as they **haven't been identified** on risk assessment processes as **material risks to banks solvency.**
- If it is on the interest of the authorities to incentivize the integration of long term objectives and interests of other relevant stakeholders in companies' culture, initiatives as the public consultation of the Commission on sustainable corporate governance could be a more powerful and appropriate tool to achieve it.

- Relying on banks' incentives to the counterparties, at least at the current stage, can lead to introduce an unjustified degree of complexity in banks' prudential framework with potential consequences over the already limited bank profitability.
- We welcome that the EBA speaks of risk drivers with regard to ESG risks. We request that the term risk driver be used consistently. The review of risk drivers for materiality is not a current practice and does not appear to be appropriate with regard to current supervisory practice.
- In the integration of ESG risks into banks' management and supervision, we would prefer if EBA uses the aforementioned taxonomy "*ESG risks*" only to refer to processes, methods and tools that apply generally to all three ESG risks categories.
- When detailing recommendations to a specific category, we consider it provides more clarity to refer only to such category. Consequently, recommendations addressed to climate/environmental risk management and supervision purposes shouldn't be reflected on the paper as general recommendations to all three ESG risks.
- Below you may find some additional comments with regard to the organization and content of the discussion paper:
  - For easier to understand future guidelines, we call for all background information that goes beyond definitions and requirements to be placed in an annex or a separate background paper in. The current arrangement of the discussion paper makes it difficult to differentiate relevant messages from background information.
  - Indeed, it is unclear what is the binding force of the methods summarized in figure 7 (Comprehensive approach to the assessment of ESG risks) in chapter 5. They are acceptable as academic versions; however, it must be possible for the institutions to also use alternative methods based on expert estimations if the complexity of the methods and data exceeds the resources of the institutions, or if they have no confidence in the methods or their validity.
  - Chapter 5.2.4: It should be emphasized that the simultaneous use of the methodological approaches presented (alignment, risk framework, exposure) may be a possible option for institutions. This should not constitute an obligation.
  - Climate risk stress testing (section 6.4.5) may be of interest for certain aspects of risk management. A distinction must be made here between internal stress testing and supervisory stress testing. For internal stress testing, the principle of methodological freedom must apply. Other aspects, such as the time scales used or the decision as to whether a stress test should be performed qualitatively or quantitatively, should be left to the institution's judgment. It is unclear how supervisory stress testing should satisfy the criteria of relevance, comparability, transparency and cost efficiency set out in the EBA discussion paper on future stress tests. Above all, less significant institutions (LSIs) will depend on a consistently formulated, simple survey methodology.
  - No specific deadline should be set to the institutions for the implementation of all measures. If deadlines are to be set, institutions must be given a sufficiently long transition period due to the need of dealing with the consequences of the COVID-19 crisis.

About ESBG (European Savings and Retail Banking Group)

ESBG represents the locally focused European banking sector, helping savings and retail banks in 21 European countries strengthen their unique approach that focuses on providing service to local communities and boosting SMEs. An advocate for a proportionate approach to banking rules, ESBG unites at EU level some 900 banks, which together employ more than 650,000 people driven to innovate at roughly 50,000 outlets. ESBG members have total assets of €5.3 trillion, provide €1 trillion in corporate loans (including to SMEs), and serve 150 million Europeans seeking retail banking services. ESBG members are committed to further unleash the promise of sustainable, responsible 21st century banking. Our transparency ID is 8765978796-80.

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