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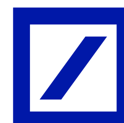

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Deutsche Bank response to EBA discussion paper on ESG risk management

2021-02-03

Dear Sir/Madam

We are grateful for the opportunity to provide comments on the future treatment of ESG risk management. The EBA Discussion Paper represents the coalescence of a lot of discussions in the last couple of years, and we recognise that the definitions provided are pioneering in the global regulatory community.

To make sure that the definitions, risk management and disclosure standards can bed in, we suggest that the EBA deploys a staggered approach, stretched over three to five years. This process should start with climate risks, as they are the most advanced in terms of operable standards and metrics.

Reflection and measurement of all of the ESG factors and risks across all risk dimensions will become a significant challenge across the banking industry, as data availability is still limited for multiple factors, and tools to measure related risk metrics are still under development. The topic of climate is by now the most advanced. However, further environmental risks, and social and governance risks, still need more time to be implemented. There is a lack of data and tools, which are still under development. A target date for implementation requirements for broader environmental and social risks in 2024 would be appropriate, and for governance risks in 2026.

Furthermore, we are concerned about the mismatch between long-term consequences of climate change (10 years+) and current risk management practices (focus on short / medium term analyses). We would appreciate EBA guidance for the development of reliable / standardised models to underpin such long-term analyses going forward.

We agree that the EBA has identified the right issues, namely allocation of risk indicators and limits within the group and different business lines; focus of institutions on the development of

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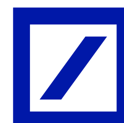


risk monitoring metrics at exposure-, counterparty-, and portfolio-level, and their categorisation by their ESG characteristics; and the need for reflection of ESG factors and associated risks as relevant parameters in institutions' credit risk analysis and in loan origination procedures. However, the details on these are too granular and prescriptive. The EBA should ensure, that institutions can take account of their specificities in their respective implementation, a one-size-fits-all approach will not be appropriate.

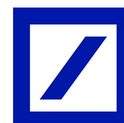
The discussion paper is geared towards negative externalities and ESG-related risks. It is concerned with effects on enterprise value and its impact on natural, human and social capital. To this extent, some of the ESG-related activity of banks and their clients will have a positive effect, both from a societal perspective and the effect on valuation of companies. 'Risk' should not only be approached from a negative perspective, but it should also provide for potential positive externalities.

Please find our responses to the discussion paper in the annex to this letter.

Sincerely yours,

Deutsche Bank AG

Johannes Pockrandt



ANNEX

Chapter 4: Common definitions of ESG factors, ESG risks and their transmission channels

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

The provided list of applicable frameworks seems comprehensive. We do not use any additional frameworks.

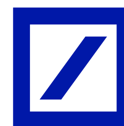
Question 2:
Please provide your views on the proposed definition of ESG factors and ESG risks.

The discussion paper is geared towards negative externalities and ESG-related risks. It is concerned with effects on enterprise value and its impact on natural, human and social capital. But in these given areas, some of the ESG-related activity of banks and their clients will have a positive effect, both from a societal perspective and the effect on valuation of companies. Therefore, the concept of ESG 'risk' should not only be approached from a negative perspective, but it should also provide for potential positive externalities. If the integration of ESG risks for banks mean that they should also recognise R&D efforts undertaken by corporates to pursue taxonomy-aligned activities or to adapt their product suite accordingly, this will likely create positive effects.

Chapter 4 includes very broad and comprehensive definitions of ESG factors, manifesting in prudential risks. It defines ESG risks as negative financial impacts on the bank from ESG factors on the bank's counterparties and ESG risks as negative materialisation of all ESG factors on prudential risks.
Reflection and measurement of all of these factors and risks across all risk dimensions will become a significant challenge, as data availability is still limited for multiple factors, and tools to measure related risk metrics are still under development.

The development of a climate risk framework is already advanced, in spite of remaining gaps in data availability, and implementation requirements for 2022 seem adequate. However, to be unambiguous and operable, the topics of broader environmental risks, and social and governance risks, in particular, need further clarification given existing gaps in terms of data, metrics and methodology. The EBA should therefore follow a staggered approach along the relative importance of these topics, and add implementation requirements once metrics have been defined and data is available. A target date for implementation requirements for broader environmental and social risks in 2024 would be appropriate, and for governance risks in 2026, respectively.

Furthermore, the EBA should ensure that the definitions, when enacted, will be aligned with all relevant European legislation, such as Recital 14 of the Sustainable Finance Disclosure Regulation. The BaFin Guidance Notice on Sustainability could also provide a model; cf pp12-13; "BaFin therefore believes that all ESG (Environmental, Social, Governance) factors should be considered. ESG factors include …" etc.



In addition, “non-financial” remains a misleading attribute as it seems to deny financial impact of the described risks/factors. These, however, will consequently have financial impacts. E, S and G risks are interdependent. For instance, Governance constitutes the basis for the other categories, as this is the corporate steering function and the first channel through which investors can exert influence. Therefore, risks identified in the area of Governance factors may spill to other areas and cause further risks, making a clear distinction as the Discussion Paper suggests impossible. The interdependence, as well as the status of Governance as the basis for the other two categories, should be clarified.

Question 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.

For the reasons stated in our response to Q2, the EBA should broaden the scope towards the positive effects, i.e. opportunities that may arise from ESG factors. This would also be consistent with the approach taken by the TCFD or the product framework pursuant to Article 9 under the EU Sustainable Finance Disclosure Regulation (SFDR) (e.g. p12: reduction of “carbon emissions as its objective”).

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

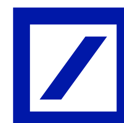
The definition of transitional and physical environmental risks in section 4.3, and their transmission channels, are broader compared to other frameworks (such as the NGFS framework). The scope should be limited on the following points:

- Physical transmission channel: extension to environmental risks (other than climate risk) makes sense; however, this needs some specific description (there are no examples given for "non-climate" related physical risks). Again, a staged approach would be necessary.
- Transition transmission channel: extension of transition channel to sovereigns is the right approach; however, the extension to private individuals does not appear adequate for these homogeneous portfolios, as relevant client data will not be readily available.

Question 5:
Please provide your 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 appreciate that the discussion paper includes social risks and governance risks. However, the definition of social and governance factors and risks, in particular, is very broad whilst there remains a fair amount of ambiguity around measurement of social factors that need further clarification. Additionally, the definitions do not really relate to existing S and G risk definitions. We propose to align these with the definitions used for example in BaFin Guidance Notice.

Covid-19 is not having a significant impact on our approach as such. However, we see that the Covid-19 pandemic and related political measures have become a catalyst for accelerated change in the economy and broader society, driving digitalisation (negatively affecting



traditional retail businesses and commercial real estate markets), but also a rethink in terms of supply chains (affecting industrial activities) and consumer preferences (affecting travel and hospitality), although it is still too early to quantify these impacts in the medium to long term.

Question 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.

We agree to the description of liability transmission channels / liability risks in general. But it should be more specific, since current wording leaves criteria and measurement unclear. It should be linked directly to the originating area (E, S or G) and not kept separately. For impact analyses, risks need quantification which can only follow when analysing the original risk in E, S or G. Mitigation and adaption strategies need such analysis to conclude on liability risks as well.

Equally as there are policy changes, the liability risk might be another driver impacting counterparties' financial stability, therefore it remains unclear why there is a need for such a differentiation.

Question 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.

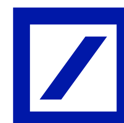
The definitions of ESG risks for credit institutions vs. investment firms should not differ. Differences may arise in materiality of ESG risks between sectors (e.g. risks of adverse environmental impacts for metals and mining vs. software industry). Additionally, certain corporate governance considerations (e.g. in capital market transactions including M&A) may be viewed differently for shareholders vs. creditors.

In addition, for investment firms, the concept of counterparties is manifold: these could be creditors in terms of bond holdings or the clients that the firm manages assets for. In case any ESG risks bring an asset manager's client base into (financial) distress, this could lead to a termination of the mandate or to a re-allocation of assets. This should be reflected within the EBA's final report.

Chapter 5: Quantitative and qualitative indicators, metrics and methods to assess ESG risks

Question found on page 53 but not in question box to chapter 5:
Do you agree with the sequential steps identified in this discussion paper for the incorporation of ESG risks in institutions' management practices? If not, please explain why.

We agree with the sequential steps identified, but the implementation for all ESG risks across all risk disciplines will take time, and therefore, recommend to follow a staggered approach (as outlined in response to Q2).



From the perspective of an investment company, every step of this staggered approach should be accompanied by corporate engagement with investees as required by, e.g. the Second Shareholder Rights Directive (SRD II), especially regarding equity holdings. We note that certain geographies (e.g. emerging markets) or asset classes (small cap, high yield) face difficulties in terms of disclosures. These should be an engagement focus in our view in order to assess ESG risks and opportunities.

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

We acknowledge that widely recognised classifications as taxonomy / market established risk management standards support transparency, and comparability of climate-related disclosures, in particular. We base our internal climate risk taxonomy on several different factors including (i) the EU taxonomy, (ii) internal analysis of carbon intensity and emissions and (iii) expert judgement. Specifics of the institutions may, however, require some degree of flexibility -- e.g. allow for certain levels of aggregation -- to manage related risks effectively. Any standards for risk indicators should allow for some flexibility in this respect.

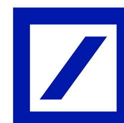
With regard to paragraph 93c [Methodological constraints], the inclusion of ESG data is not (yet) possible for statistical based and IRBA-approved models (reference to example should be deleted).

Question 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.

We acknowledge that the identification, measurement, monitoring and management of ESG risks require a set of qualitative and quantitative indicators, and we have started to develop tools to integrate climate related indicators into our portfolio databases and risk management frameworks. However, availability of ESG indicators will evolve over time -- esp. for broader environmental or social risks -- and upgrades to our infrastructure and reflection at a portfolio level will take time to develop.

The development of a climate risk framework is already advanced, despite still existing gaps in terms of data availability, and implementation requirements for 2022 are adequate. However, the topics of broader environmental risks, and social and governance risks in particular, need further clarification given existing gaps in terms of data, metrics and methodology, to be unambiguous and operable. The EBA should therefore follow a staggered approach along the relative importance of these topics, and to add implementation requirements once metrics have been defined and data is available. Appropriate would be a target date for implementation requirements for broader environmental and social risks in 2024, and for governance risks in 2026, respectively.

This section needs to clarify that the list of criteria in annex 1 is not mandatory and can be used as reference points to consider. Additionally, level, transparency and reliability of disclosure is a relevant aspect that should be covered.



DWS, our asset management subsidiary, already makes use of various providers of ESG data from third parties (MSCI, Morningstar ESG, ISS, S&P TruCost and Arabesque), and DWS are in regular dialogue with these about taxonomy-relevant ESG data. DWS also applied for the Febelfin label and is considering further European labels.

Question 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.

In 2020, we have started to develop a portfolio alignment approach covering climate related risks, to analyse and steer our portfolio positioning relative to global targets and internal goals. We acknowledge that full integration into risk frameworks and alignment with business strategies is challenging, and need time. However, this is our clear ambition.

DWS, our asset management subsidiary, announced in 2020 to become carbon neutral in alignment with the Paris Agreement already before the regulatory target date. It is a founding member of the net zero asset manager alliance. This requires to start managing portfolios aligned with this approach over the medium term. Since 2020, DWS has a committee-based approach to mitigating extreme risks stemming from poor-rated issuers in terms of ESG. These poorly-rated issuers can only be invested in upon obtaining prior approval by the Committee for Responsible Investments at DWS.

Question 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.

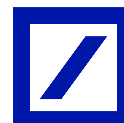
We are already using approaches that are being considered as risk framework methods by the EBA.

In 2019, we performed a bottom-up transition scenario analysis for our loan portfolios in selected carbon-intensive industries: oil and gas, utilities (electric power and natural gas), transportation, as well as steel, metals, and mining. For this purpose, we used the IEA Sustainable Development Scenario (SDS), and assessed portfolio impact by applying downward probability of default rating migrations, and expected losses.

In 2020, we started to develop a holistic approach to transition scenario analysis that can be applied across all sectors by combining sales and operating margin data at a client and sector level with actual emissions data, assumptions regarding carbon costs / taxes, transition capex, and effects from potential demand contraction for a range of different temperature and policy scenarios.

To support the development of our scenario analysis (and broader TCFD implementation) we have participated in the second phase of the UNEP FI pilot project.

DWS, our asset management subsidiary, already uses IEA-based scenario analysis sourced from S&P TruCost in its assessment of climate transition risk. This is embedded in its ESG



Engine and our Climate Transition Risk score. This is the basis for its committee-based smart integration approach, which it uses as a measure to manage sustainability risk / ESG risks.

Question 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 intend to integrate ESG risks more explicitly in our credit and rating process, which guides internal counterparty rating assessment and credit decision taking, to support consistent application and documentation of qualitative input in credit and rating analysis following wider data availability with better disclosure requirements. This will complement and better substantiate already existing expert factors on special risk that include environmental risk already today. Credit risk analysis is one key work stream in our development project. However, for the purpose of portfolio risk identification and steering we prefer a holistic approach, incorporating the portfolio alignment approach and "top-down" scenario analysis, in particular.

We understand the discussion paper as proposing that the exposure method can be simply used to complement a qualitative assessment of climate risk in PD under IRBA approved methodologies. We also understand that it is the institutions' choice whether they use external climate ratings or internal methodologies.

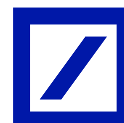
As for paragraphs 143 and 145, it is not entirely clear why this method "requires a substantial amount of evaluation in retrospect" or why it is considered static and largely reliant on backward-looking data" since some of ESG ratings focus on current emission levels and take targets into account.

Running full ESG due diligence for every client relationship is not viable, as comprehensive data is not readily available in many sectors and sizes of business. The wording should:

(1) emphasise the importance to differentiate by sector and, potentially, location, meaning to (i) develop sector-specific policies/regional approaches; (ii) engage with clients; and (iii) undertake enhanced due diligence (including escalation to committee) only for clients/transactions that have material environmental and/or climate related risk, and
(2) define exposure thresholds for the proposed risk assessment and enhanced due diligence, to limit the analysis to exposures that have some significance.

Especially SMEs and non-EU-based clients will not face legal disclosure requirements at this point in time, making it very challenging for banks to conduct climate-related and environmental due diligence in these cases. Moreover, it remains unclear how client categories such as banks and sovereigns are to be treated.

Regarding retail portfolios, the focus should change from individual client due diligence to portfolio specifics (e.g. employment sectors, collateral, product suitability) with a specific focus on mortgage valuation as the main lever for ESG relevance in retail apart from investment products. We want to emphasise the importance of aligning EU taxonomy with national building codes and certifications, which is currently lacking. Without the latter, a standardized classification for further usage in data and models across Europe and within countries will be impossible.



Question 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.

No.

Question 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 the context of individual investors, a client's preference and desired strategy may not be that their portfolio comprises solely or substantially of "ESG investments". Therefore, asset managers should not be required to apply prescriptive conditions or thresholds having that effect. Nonetheless, it is reasonable that all portfolios and their underlying products should be assessed, to identify any products that pose a higher environmental risk and therefore trigger any enhanced monitoring.

Each asset manager should select appropriate risk management tools that are relevant to their business, rather than there being a prescriptive set of tools/metrics.

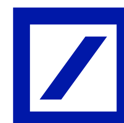
For example, asset managers' real estate businesses do not typically invest in investee companies. In the context of our wealth management business, rather than being an asset owner there is a fiduciary duty to the client and engagement with underlying investee companies is limited. Nonetheless, our retail operation (Private Bank) has a stringent investment process, which excludes a number of high risk sectors from the investment universe. This will be further enhanced through the integration of Environmental Risks in the coming years, including the incorporation of management of any accepted high risks.

The EBA should clarify that, when an asset manager acts in a fiduciary role for a client, instead of as an asset owner, it has very limited capacity to engage with the investee company. Thus, the duties of asset managers should be limited accordingly in cases where they are not the asset owner.

DWS, our asset management subsidiary, has developed a strong corporate governance framework and reviews its expectations annually. Our engagement approach and our proxy voting framework include an internal ESG-rating derived from our proprietary ESG-engine and based on external ESG-data. The Group has appointed a Group Sustainability Officer to drive DWS's ESG strategy and to coordinate efforts in this direction.

Furthermore, DWS has developed an ESG-strategy blueprint to fulfil its net zero ambitions and through the IIGCC net zero asset manager alliance. It has set increased minimum ESG standards for its actively managed mutual funds business which need prior approval from a committee for responsible investments if they want to invest in poorly ESG-rated securities. In addition, ESG integration and engagement policies foresee mandatory corporate engagement rules. To be best possible extent, DWS will closely link any climate strategy ambitions with recommendations from the TCFD.

Due to the considerable work that asset managers have put into such frameworks, any regulation of risk management tools / metric, should be principle-based. It should ensure that



each asset manager has the ability to select appropriate risk management tools that are relevant to their business.

Chapter 6: The management of ESG risks by institutions

Question 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.

Smaller institutions may also be susceptible to ESG-risks, and therefore, will need to effectively identify and monitor the ESG risks to which they might be exposed, and should implement adequate measures to address them.

To keep the standards manageable for credit institutions, it is advisable to consolidate subsidiaries on a group level. This will both provide a better overall view on the institution, as well as ensuring feasibility over banking groups.

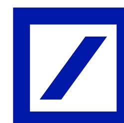
Question 16:
Through which measures could the adoption of strategic ESG risk-related objectives and/or limits be further supported?

Environmental risks, in the form of physical and transition risks in particular, have implications for global portfolios. Therefore, scenario analyses and stress tests will become pivotal tools to manage related risks. Since diversified institutions with meaningful global operations benefit from broad diversification, we recommend to limit scenario analysis and stress testing to physical and transition-related risks specifically. On the other hand, reputational risks tend to be idiosyncratic by nature and are difficult to quantify. Therefore, scenario analysis or stress testing for these risks are not done at a global portfolio level.

We do have sector-specific policies in place, and for instance, have tightened our Fossil Fuels Policy in 2020. We have piloted scenario analyses using bottom-up approaches for the most sensitive industry portfolios, and are developing a more holistic top-down approach to assess impacts of a range of policy scenarios on our overall CB&IB loan portfolios. All of these points would be necessary for principles for a prudent climate risk management framework.

We participate in the 2020 EBA sensitivity exercise. Nevertheless, we are facing challenges to develop genuine ESG Stress Tests. We share the concerns articulated in the GARP survey (May 2020) re: the mismatch between long-term consequences of climate change (>10 years) and current risk management practices (focus on short / medium term analyses). We would appreciate EBA guidance for the development of reliable / standardised models to underpin such long-term analyses going forward. This is also one reason for our participation in the 2020 EBA Sensitivity Exercise.

From an investment firm perspective, we regard best-in-class or best-in-universe approaches as more effective if they are coupled with certain minimum ESG investment standards. Furthermore, corporate engagement and investment stewardship are powerful tools.



The points b) “more long-term” (point 154 b), p80) and c) “longer-time horizon than 3-5 years” (policy recommendations, p128) are challenging for financial institutions. We recommend an assessment in a shorter horizon as accuracy decreases into the future. Even if environmental considerations are analysed 10 years to the future, this should not be applied to all aspects of business model analysis. Focusing on the beginning of the environmental risk curve in the context of other reasonably known information would be more appropriate.

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

The most appropriate way of integration into the business strategies and processes of institutions is by taking a holistic view on which risks might be impacted / aggravated by climate change. In practice, such as: exposure to certain industries (transition risk), impact on people, offices, etc. (physical risk) and transactions / client relationships which may have a reputational impact (reputational risk).

We recommend to employ a two-step approach on industry restrictions. For example, we set out general provisions in our Environmental and Social Policy Framework, which define sensitive sectors we focus on, specify the requirements for Environmental and Social due diligence, and include criteria for mandatory referral to our Group Sustainability department. The industry portfolio restrictions are complementary to this framework.

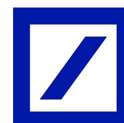
More broadly, the development of scenario analysis will be a key component of our climate risk management framework to ensure that we develop our understanding of downside risks and take appropriate actions.

On a general note, the coming EBA standards should reflect that climate-related metrics are still being developed. Full integration into business and risk strategies remains dependent on progress in such projects, making a phased approach necessary.

We agree that institutions will need to align Business and Risk information requirements and data bases, strategies, policies and procedures further. However, the wording of section 6.3, paras 172, 175, 177 reads too prescriptive with respect to granularity, breakdowns, etc., and instead, should allow for some flexibility to account for specifics of the institutions.

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

Existing governance structures within an institution should be used to most efficiently and effectively integrate these specific risks into effective risk management. The respective management body has an overarching responsibility for the management of the legal entity and needs to make sure it has a proper organisation in place which deals with the different aspects of risks, including ESG risk. Risk topics usually are allocated to a specific board member, which includes the responsibility for ESG risk. Within a proper delegation within this risk function the respective board member may delegate specific responsibilities further down the organisation. The delegation to one or more positions accountable for ESG risk with clear responsibilities would be the most efficient and transparent way to integrate this topic into the existing



governance structures. This position may then establish groups to support him / her with proper decision making, but in order to avoid dilution of accountability, no joint decision making is suggested.

Where individuals or committees are confronted with ESG topics regular updates (standing agenda) should be provided by the respective responsible position holders.

The Management Body is responsible for the overall business and risk strategy which also includes the strategy around ESG. Given it is the legal responsibility and accountability of this management Body, it is in their remit to identify and define the respective strategy around ESG. Remuneration policies will be linked to such business and risk strategy to provide incentives to implement the respective strategies.

Regarding loan origination, the EBA Guidelines on loan origination and monitoring only refers to climate being reflected in collateral. The EBA's final report should be aligned with this. A direct linkage into loss given default (LGD) does not seem appropriate.

We agree that institutions will need to continue to strengthen governance and align procedures at an operating level (e.g. via clearer definition Roles & Responsibilities of 1LoD, 2LoD, Compliance, Audit, etc): We do have governance arrangements in place, with responsibilities assigned to our Sustainability Committee (chaired by the CEO), Sustainability Council, GRC, ERC, RRC etc. In addition, variable remuneration for Board members should be linked to sustainability targets.

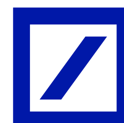
Nevertheless, the wording of section 6.3, paras 197, 198, 199, 207 reads too prescriptive with respect to the role of the Management Board. Instead, we suggest to allow for some flexibility and scope for delegation to account for the institutions' specifics and varying levels of complexity.

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

It is reasonable that all portfolios and their underlying products should be assessed to identify any products that pose a higher environmental risk and therefore trigger any enhanced monitoring. Enhanced monitoring should only be required for investments that pose a higher environmental risk.

Running comprehensive ESG due diligence for every client relationship is not viable, as comprehensive data is not readily available in many sectors and sizes of business. The wording should emphasise the importance to differentiate by sector and, potentially, location, meaning to (i) develop sector-specific policies/regional approaches; (ii) engage with clients; and (iii) undertake enhanced due diligence (including escalation to committee) only for clients/transaction that have material environmental and/or climate related risk; and define exposure thresholds for the proposed risk assessment and enhanced due diligence, to limit the analysis to exposures that have some significance.

Especially SMEs and non-EU-based clients will not have disclosure requirements, making it very challenging for banks to conduct climate-related and environmental due diligence in these



cases. Moreover, it remains unclear how client categories such as banks and sovereigns are to be treated.

A large problem of this is the availability of data. This fact should be reflected in the upcoming EBA guidelines. We will jointly develop measurement methods and appropriate approaches to manage banking business in line with the goals of the Paris Agreement, but this will take time.

Indicators used regarding broader environmental and social risks may include:
- Number of matters assessed through a bank's reputational risk framework due to environmental / social issues – volume to be tracked throughout the year and analysed.
- Number of transactions reviewed under the bank's Environmental and Social Policy Framework, as well as percentage per sector.

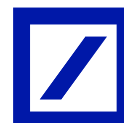
We are preparing a climate risk principles document, including qualitative risk appetite statements, which has been discussed at the Enterprise Risk Committee and will be finalised before the end of the year. The document will articulate the group's overall approach to climate risk.

We are in parallel working on the development of specific metrics and risk appetite targets to enable us to measure and control climate related risks according to the above principles and aligned with our public commitments including the Paris agreement. We have classified our Corporate Bank and Investment Bank portfolio along our sectoral taxonomy (at a group level), but this needs refinement to reflect counterparty specific data.

There is no dedicated climate / environmental risk reporting in place today, but existing risk reporting does reflect some aspect of this. We are developing relevant reporting, utilising our internal risk taxonomy referred to above, for senior management. Reporting will commence in the third quarter of 2020.

Regarding 19(f), all companies are exposed to governance risks so "assets exposed to governance risks" would be equivalent to all corporate customers. Referencing our remarks on question 5, the wording should be changed to remove requirements or further clarification and adding of substance which would enable specific actions to be taken, should be added.

We agree that EBA is addressing the right issues, namely allocation of risk indicators and limits within the group and different business lines; focus of institutions on the development of risk monitoring metrics at exposure-, counterparty-, and portfolio-level, and their categorisation by their ESG characteristics; and the need for reflection of ESG factors and associated risks as relevant parameters in institutions' credit risk analysis and in loan origination procedures. However, the details on these are too granular and prescriptive. Specifically:
- The details of paragraph 222 should allow for some flexibility in terms of aggregation levels to account for institutions' specifics and complexity.
- The contents of paragraph 226 are too prescriptive and granular. They should allow for some flexibility to account for institutions' and counterparties' specifics, e.g. when analysing global corporates or banks that require a higher aggregation level in our view.
- The wording of paragraph 6.4 233 needs some clarification, as there is no guidance on how this should be approached. ESG-risk can be reflected within existing models and scorecards.



The examples raised in para 238 are most likely not the most common ones. Risk drivers that are more prominent to have an impact on financial performance and as such on PD are regulatory policies, costs of transitioning for names with high transition risk etc. It should allow qualitative input, but no statistics-based input. This also applies to the methodology constraints raised in para 93. With regard to EAD and LGD, modelling such components is challenging. The loan origination guidelines only refer to climate being reflected in collateral. A direct linkage into LGD does not seem appropriate. The upcoming EBA report should contain an alignment.

With reference to paragraph 253, ESG risk will be adequately reflected in pricing via the counterparty and portfolio risk assessment, but EBA should abstain from additional charges for less sustainable activities, since (i) institutions have a strong incentive to align portfolios to the Paris Agreement targets anyhow, whilst (ii) need to avoid unintended negative consequences for companies and sectors that face the most significant challenges to transition to a low-carbon economy.

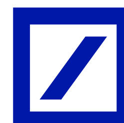
As stated before in our response to question 12, regarding retail portfolios, the focus should from individual client due diligence to portfolio specifics (e.g. employment sectors, collateral, product suitability) with a specific focus on mortgage valuation as the main lever for ESG relevance in retail apart from investment products. We want to emphasise the importance of aligning EU taxonomy with national building codes and certifications, which is currently lacking. Without the latter, a standardised classification for further usage in data and models across Europe and within countries will be impossible.

Question 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.

We refer to our response to Q5: Topics apart from environmental risks are not sufficiently advanced to create implementation requirements that are sufficiently clear. Social and governance risks, e.g., need further clarification and added substance to be unambiguous and operable.

The EBA acknowledges that limited availability of data could hamper this quantitative analysis, especially for social and governance risks. As yet, there is no guidance for quantitative metrics for assessing and monitoring social and governance risks. Nevertheless, institutions will be asked to calculate indicators such as volume of outstanding assets from counterparties particularly exposed to social and governance issues.
Significant ambiguity will remain around the coverage of these key elements in the near term.

The development of a climate risk framework is already advanced, despite still existing gaps in terms of data availability, and implementation requirements for 2022 are adequate. However, the topics of broader environmental risks, and social and governance risks in particular, need further clarification given existing gaps in terms of data, metrics and methodology, to be unambiguous and operable. The EBA should therefore follow a staggered approach along the relative importance of these topics, and to add implementation requirements once metrics have been defined and data is available. We recommend a target date for implementation



requirements for broader environmental and social risks in 2024, and for governance risks in 2026, respectively.

Question 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.

We agree with the appointment of an individual or committee to be responsible for each fund/mandate, providing this is not prescriptive in terms of any preferred structure, as this is likely to vary according to the nature of the fund/mandate. For example, for a Real Estate Investment Trust (REIT), this might be a committee, given the scale of the assets under management; however for a more boutique fund, this might be an individual. For investments into liquid underlyings (equity / bonds of corporates or sovereign bonds), there should be a regular review process with an aggregation across portfolios with regular reporting to the management board level or a dedicated ESG committee (with sufficiently senior staffing). In line with recommendations from e.g. BaFin guidance notice, it is advisable to have a sustainability risk department which can propose thresholds in terms of ESG quality or define sustainability risk appetite overall.

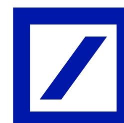
Chapter 7: ESG factors and ESG risks in supervision

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

Capacity-building should form part of banks' overall strategy. Examples on how to implement this include:

- Support for employee training via the sustainability function, enabling businesses to better identify ES risks and consequently assess and refer transactions with an enhanced risk profile to the sustainability function.
- Enhancement of the timeliness of transactional referrals by using reminders within internal deal logging system.
- A network of regional 'ESG Ambassadors' to serve as first points of contact on ESG-related financial matters, and generate/opine on ideas for integrating ESG into the business offering.
- Establishing a working group across all disciplines in the Risk division, to develop the institution's climate risk framework. Offering relevant employees (e.g. wealth management) the European Federation of Financial Analysts Societies (EFFAS) web-based certified ESG analyst course.

Referencing our remarks on questions 3, supervision / business model analysis should consider upsides of the evolving business mix / first mover advantage and others. The discussion paper is very much focussed on risks / downsides. EBA should also encourage positive steps of institutions to advance the growth of sustainable-finance solutions, which, if significant, will also make a positive contribution towards lowering transition risks.



EBA proposes the supervisory review to be structured around the main six SREP elements: business model analysis, internal governance and institution wide controls, risks to capital, risks to liquidity and funding, SREP capital assessment and SREP liquidity assessment.

It remains unclear to what extent the review will be integrated into broader SREP processes. We suggest that this should be the case, given that EBA considers ESG risks to be drivers of prudential risks -- or it should be conducted completely separately. The final EBA report should be clear on this issue.

Question 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.

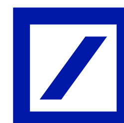
We recommend the assessment in a shorter horizon, as accuracy decreases into the future. Even if environmental considerations are analysed 10 years to the future, this should not be applied to all aspects of business model analysis. Focusing on the beginning of the environmental risk curve in the context of other reasonably known information would be more appropriate.

Given the differences in time horizons between the acknowledged >10 years for ESG risks impacts and current supervisory reviews, ESG risks cannot be fully captured by the existing review practices.

In terms of business model analysis (section 7.3.2), the long-term resilience assessment would be a new aspect of the supervisory assessment and go beyond the minimum time horizon of 3 years currently expected based on the SREP Guidelines – it would be aligned with non-financial regulation policy such as the emission reduction targets set for 2030. Whilst this seems conceivable for climate risks, expansion of the supervisory review to broader S- and G-risks would become extremely challenging, given existing gaps in terms of data, metrics and methodology, in particular. Therefore, EBA should adopt a staggered approach, e.g. as outlined in response to Q2, to start with the more "mature" framework for management of climate risk, and to add social and governance risks once metrics and methodology have been defined and data is available – in a second and third step.

Given that industry standards for modelling of ESG-risks and stress testing portfolios are still in early stages of development, EBA will need to provide guidance on acceptable methodologies, models and input parameters. Given the uncertainty around potential economic outcomes and financial impacts from ESG-risks, we suggest to take a split approach, to conduct quantitative analysis over a shorter time horizon (<three years), whilst expanding qualitative analysis over a longer period of time (e.g. 10 years).

The EBA acknowledges (7.3 312) that "the existing assessment would probably not sufficiently enable supervisors to understand the longer term breadth and magnitude of impact of ESG risks on future financial positions". As outlined in our comments on Chapters 4-6, the development of a climate risk framework is already advanced, despite still existing gaps in terms of data availability, and implementation requirements for 2022 are adequate, in our view.



However, the topics of broader environmental risks, and social and governance risks in particular, need further clarification given existing gaps in terms of data, metrics and methodology, to be unambiguous and operable. The EBA should therefore follow a staggered approach along the relative importance of these topics, and to add implementation requirements once metrics have been defined and data is available. Appropriate would be a target date for implementation requirements for broader environmental and social risks in 2024, and for governance risks in 2026, respectively.

In terms of review of the strategy and financial plans (section 7.3.3), the assessment of business model and viability (section 7.3.4), our above comments re stepwise implementation over an extended period of time equally apply.

Question 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.

Regarding supervisory review of controls / the risk management framework, the stress testing capabilities requirement (paragraph 325) and on information and communication systems (paragraph 327) should provide for the time needed for ongoing development efforts, as methodologies and tools to assess, quantify and monitor ESG-risks are being developed currently, as operating systems need to be upgraded.

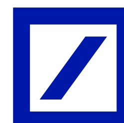
Not all banks may be able to complete this by the end of 2021, esp. if including broader S- and G-risks. Therefore, a longer timeframe into 2022 is recommendable.

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

We see little impact on own debt issuance and wholesale funding. Reputational risk is always a concern for liquidity, but only as a second-order impact. Therefore, it is more appropriate for the reputational risk team to manage this. We also do not see much impact on liquid assets, as we only give value to central bank eligible assets. Price volatility is more appropriate to be handled in the context of market risk than liquidity risk.

The main sources of liquidity risk are: (i) committed facilities outflows from industry segments (as opposed to geographies) impacted by environmental risks, such as insurance companies impact by physical risk-related claim increases or the oil and gas industry suffering from falling demand for their products; and (ii) deposit outflows in transaction banking related to the above.

The impact of ESG risks materialises in the form of existing prudential risks. Existing credit risk models are based on historical data. In contrast, a separate ESG charge (if any) could be applied based on categories of activity and the ESG factors/ risks that the institution is subject to – this is analogous to transfer risk, which is a separate charge to a normal credit risk capital charge for those affected exposures. In particular, the 'slotting approach' as with specialised lending exposures could be applied for institutions subject to ESG factors and risks. This classification would be determined based on existing taxonomies for certain types of activity (question 19), and the capital charge would be the sum of a normal credit risk charge and the ESG charge (if any). In this context, it is key to ensure the flexibility that this charge could be



positive or negative. Therefore, the existing model calibration would be preserved, and the forward looking nature of ESG risks could be incorporated into the solvency framework.

In terms of risks to capital, more specifically inherent credit risk / sectoral concentration, we understand from paragraph 336 (section 7.5) that EBA acknowledges the fact that quantification exercises are more developed for climate and environmental risks than for social and governance factors, and that supervisors might expect credit institutions to investigate such ESG sectoral concentration analysis in a qualitative form. This approach is appropriate and should be carried into the final EBA report.

Re geographical concentration, in paragraph 337 (section 7.5), EBA points to the availability of physical risk metrics from academics. Usefulness of such data, however, is limited, e.g. for portfolios of multinational companies owning a broad portfolio of assets. EBA states that with the improvement of methodologies and the availability of data, geographical analysis of physical risk can be extended to the entire value chain. EBA should clarify that such analysis may not be readily available for all portfolios in the near term.

Funding derived from home loan savings or similar long-term schemes geared towards long term build-up of pension assets for lower and middle income populations should get preferential treatment under risk and ESG considerations as their purpose and long term nature supports the development goals.

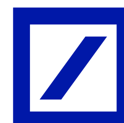
Regarding the impact of ESG risk factors on credit risk and thereby on the capital position of the credit institution, the European Commission and the Energy Efficiency Financial Institutions Group (EEFIG), specifically working group number 8 on risk assessment is examining the quantitative relationship between energy efficiency improvements and lower probability of default of associated loans and the increased value of the underlying assets. We participate in this group. An interim report from this working group has been confidentially provided to the European Commission (DG Energy) in January 2021.

The working group examined publications on the suitability of ESG factors (in that particular case e.g. energy performance certificates) for risk differentiation: There are several studies undertaken by regulators, banks and academics indicating that the investment in energy efficiency measures has a lower credit risk compared to other loans. This is due to their lower cost for heat and power (and a green premium in value terms), lowering cash spend both on a monthly basis and over the full lifetime of loans and real estate assets.

This goes back to our prior point under Q2 that the assessment of risks to capital includes both the upside and downside regarding credit risk: ESG factor can increase the risk a bank is exposed to, but there can be also ESG factors leading to a reduction of risk.

Question 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.

We do not have any further comments here.



Question 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?

As a general point, EBA should clarify under which established risk management methodology the risk is expected to be considered. For example, given the detailed requirements by EBA for the estimation of IRB credit risk parameter (EBA/GL/2017/16) under Basel pillar 1, a large degree of alignment between those requirements and EBA's methodology of the risks to capital would allow harnessing existing risk management frameworks.

The risk management methodologies to be explicitly mentioned should include at least:

- Basel pillar I methodologies like IRB, standardized approach, etc. as described in the CRR, EBA guidelines and ECB guides.
- Basel pillar II and the requirements of the SREP, in particular outlining the envisaged usage of ESG factors under the economic and normative perspective
- IFRS9 lifetime expected loss modelling, and
- internal and supervisory stress testing.

Question 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.

We have disclosed loan exposures to carbon- intensive sectors (also as % of total) for a few years now. More importantly, we are in the process of developing methodologies, tools and metrics to assess, measure and monitor climate risks. In this context, we have started using indicators such as scope 1, 2, 3 GHG emissions (tonnes of CO2), and carbon intensity of our credit portfolio, in particular. At the same time, we are developing a methodology to measure and monitor alignment of our portfolios to the Paris Agreement targets.

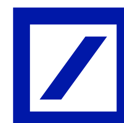
Of course, we are also developing our risk framework re the measurement and monitoring of physical risk, however, this project work stream will still need to select adequate metrics that are suited to our portfolio profiles.

Question 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.

If we were to track our scope 3 emissions (i.e. emissions caused by our clients), then data availability regardless of the ESG factor would be the most limiting point.

The Regulatory Technical Standards (RTS) for the Sustainable Finance Disclosure Regulation (SFDR-RTS) will likely only fully cover EU-clients. The RTS will likely not cover an entire universe of our client base (e.g. geographically and size-wise) meaning that the underlying data will be incomplete. It is unknown at this stage whether the clients will be able to report even those measurements. The definitions provide for relatively substantial room for interpretation, and therefore might produce different results for the same company.

Non-financial reporting is currently excluded from statutory audit, and hence might be provided on a best-effort basis rather than being fully reliable. In addition, at present, a number of



varying reporting standards are applied globally. This should be addressed in the on-going review of the Non-Financial Reporting Directive.

A further obstacle is the non-regulated nature of external ESG-assessment providers with proprietary methodologies, reliant on questionnaires and current public (not-standardised) disclosures of rated entities. This yields very different outcomes for the same company. A regulation of ESG ratings would provide clarity and transparency.