

Rome, 17th April 2024

Federcasse comments on EBA Draft Guidelines on the management of ESG risks (EBA/CP/2024/02)

Question 1: Do you have comments on the EBA's understanding of the plans required by Article 76(2) of the CRD, including the definition provided in paragraph 17 and the articulation of these plans with other EU requirements in particular under CSRD and the draft CSDDD?

Referring to Article 76(2) of the CRD, we concur with the EBA's proposition, and we endorse its interpretation. The Board of Directors must allocate time and resources to defining precise prudential transition plans, establishing measurable objectives, and implementing procedures for monitoring and mitigating risks arising from ESG factors.

In relation to aligning (transitions) plans with other EU regulations, it's crucial to highlight that existing legislation (e.g. the SFDR) provides definitions of sustainability risk and sustainability factors. Understanding these definitions is key to developing a unified framework between the prudential regulations for banks and ESG policies.

Article 2, paragraph 22 SFRD outlines that *'sustainability risk' means an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment.*

Paragraph 24 extends this definition by specifying that *'sustainability factors' mean environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.*

We consider it imperative to thoroughly examine these matters to delineate a scope for the application of the Guidelines under review. Understanding the nature of the phenomena, events, or conditions is fundamental to subsequently identifying the dynamics of the associated risks and their resultant potential impacts. Two challenges emerge at this point:

- the primary challenge lies in "operationalizing" the concept of sustainability risk within the social sphere. The objective is to delineate the relevant social sphere as comprehensively as possible and establish characteristics conducive to precise analysis. Conversely, regarding environmental risk, there exists a level of "operationalization" that is deemed acceptable, though not yet complete. This progress is facilitated by the increasingly scientific basis upon which environmental criteria are defined and supported;
- the second significant challenge is to identify what is the real integration of social sustainability within financial decisions and devising strategies to mitigate the



potential paradox between the principles of the prudential framework for credit and finance and those of social sustainability.

Indeed, the traditional prudential approach may no longer be fully equipped to assess social risk comprehensively. Consequently, **there may be a need to innovate the prudential approach to consider not only the financial risk associated with social issues but also the "merit" of investment choices that focus precisely on addressing the social issues at stake.** In other words, an investment deemed prudent in the past may no longer align with social sustainability or may even contribute to perpetuating negative social conditions.

Hence, it is crucial to delve into the concept of social sustainability risk and develop methodologies and tools to effectively integrate it into financial risk assessment. Only then can we ensure that investment decisions are genuinely sustainable and contribute to long-term social and environmental well-being.

Should it prove challenging to delve into this concept, it would be necessary to clarify in greater detail that the guidelines primarily address environmental sustainability, and that further exploration will be undertaken to fully integrate social sustainability into decision-making and prudential processes.

Question 2: Do you have comments on the proportionality approach taken by the EBA for these guidelines?

We believe that the proportionality approach adopted by the EBA in its Guidelines may have significant implications, especially for small and medium-sized enterprises (SMEs).

The guidelines allow smaller and non-complex institutions (SNCIs) to implement less complex or sophisticated provisions, and in some cases, even on a voluntary basis, following the principle of proportionality. However, there is a risk that prudential principles regarding ESG sustainability factors (along with reporting requirements imposed by the CSRD) may come into effect "*de facto*", even if not legally binding. The adoption of such principles, even if voluntary, could indeed establish a new "operationally obligatory" standard to which both financial stakeholders (such as banks, insurers, venture capital investors) and major commercial stakeholders (such as customers and suppliers) will refer.

In conclusion, it is necessary to delve into the impacts of adopting these Guidelines designed for large enterprises on the operations of small businesses. It is essential to ensure that SMEs receive the necessary support to address challenges and adopt sustainability practices without being penalised financially.

Question 3: Do you have comments on the approach taken by the EBA regarding the consideration of, respectively, climate, environmental, and social and governance risks? Based on your experience, do you see a need for further guidance on how to handle interactions between various types of risks (e.g. climate versus biodiversity, or E versus S and/or G) from a risk management perspective? If yes, please elaborate and provide suggestions.

Building upon the observations outlined in response to question 1, it is evident (yet essential) that “operationalizing” the concept of sustainability risk and factor concerning the social sphere poses significant challenges.

While it is deemed essential to consider and incorporate social risks within prudential assessments, it is equally crucial to acknowledge the **inadequacy** of existing definitions and application frameworks. Therefore, delving deeper into the concept of social sustainability risk associated with capital allocation decisions, developing appropriate methodologies and tools to identify it, track its dynamics, and assess its potential impacts are deemed essential.

With regards to the interplay between environmental, social, and governance risks, there is a perceived necessity to employ a **multidimensional approach**, in which efforts are made to elevate social and environmental considerations to an equal level. Specifically, the importance of **considering the potential social impacts stemming from the design and implementation of policies and practices for the green transition is emphasized**, aiming to ensure a fair and inclusive process.

If not properly managed, the green transition could indeed give rise to various phenomena that may impact the social sphere, including:

- unemployment: due to the closure of industries linked to traditional sectors with high environmental impact;
- economic inequality: the push towards green technologies could result in higher costs for electricity or transportation, which might disproportionately burden economic system operators;
- social exclusion: technological solutions for the green transition might not be accessible to everyone, potentially widening the social gap.

We believe that only through an integrated and proactive management of ESG risks, encompassing all three spheres (environmental, social, and governance), can we adequately assess the impacts and risks associated with ESG factors, and ensure the long-term sustainability of activities and society as a whole.

Question 4: Do you have comments on the materiality assessment to be performed by institutions?

The concept of materiality addressed in the Guidelines seems tailor-made for environmental risks and factors. As discussed in previous responses, there is a perceived lack of suitable definitions enabling the analysis and quantification of the social factors.

Unlike what can be achieved with climate sustainability risk and factors, where the concept of materiality is supported by an objective scientific basis closely aligned with the standards of the so-called "exact sciences," a similar elaboration is still lacking in the social sphere.

In this regard, it is deemed essential to develop a **social taxonomy** as a starting point for the regulatory definition of social factors and their scope. Therefore, it is desirable for European policymakers (Commission, Parliament, Council, and EBA) to reopen the social taxonomy project. In this context, the considerations and provisions outlined in the Commission's Action Plan on Social Economy and the Council's Recommendation on the development of the framework conditions for social economy must serve as an indispensable starting point.

Furthermore, it is not feasible to have a tool analogous to environmental and climate materiality in the social sphere without starting from the concept of the **intentionality of business operations**. That is to say, to identify and measure social risk, it is essential to consider the purpose and objective of the social economy, namely that the enterprise aims not at profit maximization but at fulfilling a social function.

As a result, within the scope of financial materiality assessment, **strong opposition is voiced against the drafting of Guidelines that may discourage economic and financial activities or investments with a social character due to their negative impact on entities in terms of capital requirements**. Instead, new incentives for investments in the social economy are suggested, including the possibility of attaching a lower risk weighting to them compared to investments with similar characteristics but detrimental or neutral to the social sphere.

Moreover, we believe that the attempt to integrate social risk into the framework of banking risk management should not proceed in conflict with the strategy for the social economy that has characterized the programs of European institutions in recent years. Addressing social factors with a prudential perspective should not harm or deter the social economy, nor should it discourage financial activities with counterparties that, in addition to traditional risks, may (arbitrarily) entail a risk assimilated to social factors.

Within the context of climate and environmental risks, the occurrence of natural events and crises has made a counteractive intervention indispensable and urgent. There is an opportunity to address social issues before reaching a crisis situation. However, it

is essential to intervene in the social sphere without discouraging investments or causing (further) competitive disadvantage.

As an example, the spread of banking desertification is attributable, among other factors, to the reduction in population and economic activities in rural areas. This condition is linked to social dynamics and can have a negative impact on investments. Within investment decisions, a banking institution may need to evaluate its exposures based (also) on their vulnerability to this condition. Such assessment should consider both prudential dynamics and, ideally, social ones.

In this context, the incentivization of **local economies** and **patient economies** that bring back to the territory the created economic value is deemed essential.

Question 5: Do you agree with the specification of a minimum set of exposures to be considered as materially exposed to environmental transition risk as per paragraphs 16 and 17, and with the reference to the EU taxonomy as a proxy for supporting justification of non-materiality? Do you think the guidelines should provide similar requirements for the materiality assessment of physical risks, social risks and governance risks? If yes, please elaborate and provide suggestions.

As previously mentioned, the social sphere markedly differs from the environmental one, making the formulation of standard and objective requirements for assessing associated risks exceedingly ambitious and complex.

Therefore, the need for developing a clear and consistent framework to identify economic activities that can be deemed socially sustainable and contribute to the social objectives of the European Union is reiterated. Such an initiative could warrant reopening the debate on **social taxonomy**, as previously indicated in earlier responses.

Question 6: Do you have comments on the data processes that institutions should have in place with regard to ESG risks?

In data collection processes, as well as in those for measuring and assessing risks, we encounter an **epistemological problem** in determining the materiality of social risk and consequently in **quantifying** the significance or relevance of a social factor in the context of prudent risk assessment.

The complexity of social factors and the lack of reliable data challenge the practical implementation of these processes and highlight their critical aspects. Moreover, the perception of materiality can vary among individuals and institutions, depending on their perspectives, values, and goals. This subjectivity in evaluations can make it

difficult to reach a consensus on what constitutes a socially significant risk that is commonly considered materially significant.

We therefore reiterate the need to delve deeper into these issues in the appropriate forums in order to define a clearer framework of application and coherent and widely acceptable guidelines.

Question 7: Do you have comments on the measurement and assessment principles?

Please refer to the answer to Q6.

Question 8: Do you have comments on the exposure-based methodology?

We believe that the exposure-based methodology for assessing and measuring ESG risks regarding credit risk profile and counterparties' profitability faces limitations that hinder its complete and coherent implementation. These limitations stem from challenges in quantifying ESG risks, especially those related to the social sphere, as well as in subsequently determining quantifiable and objective criteria.

For further considerations regarding the integration of ESG risks into the credit risk profile, please refer to the response to question 15.

Question 9: Do you have comments on the portfolio alignment methodologies, including the reference to the IEA net zero scenario? Should the guidelines provide further details on the specific scenarios and/or climate portfolio alignment methodologies that institutions should use? If yes, please elaborate and provide suggestions.

We have no comments on this.

Question 10: Do you have comments on the ESG risks management principles?

Please refer to the answers to Q1 and Q3.

Question 11: Do you have comments on section 5.2 – consideration of ESG risks in strategies and business models?

As the integration of ESG risks into business models varies depending on the sector, size, and geographical location of each company, we deem it important to emphasize that while it is essential for all financial entities to incorporate ESG factors into their

business models, it is equally crucial **to recognize the operational nature of banks, which** – both due to their legal structure and the type of business they adopt – **operate de facto as social economy entities.**

It is therefore appropriate to consider these business models within the framework of prudential supervision, aiming **to balance** the need to strengthen their capitalization against the risks they assume with the promotion of green and sustainable financing. Further reflections are encouraged in this regard to **promote business models strongly focused on the social economy and to develop consistent supervisory policies and approaches**, along with appropriate support tools.

In particular, we hope for **improved access to credit for social economy entities** as a means to raise the focus of companies on social issues (such as low productivity and slow growth associated with long-term unemployment, inequality, unequal access to education, and human rights violations), fostering investments in disadvantaged areas and promoting their development, as well as incentivizing the green and digital transition. This targeted approach can significantly contribute to the promotion of **inclusive and sustainable economic growth.**

Question 12: Do you have comments on section 5.3 – consideration of ESG risks in risk appetite?

It's crucial to carefully analyse banks' risk appetite, especially in a financial context where investment decisions are guided by expectations of returns, riskiness, and duration. However, we must recognize that these criteria may conflict with environmental and social interests or may even override them.

Understanding that there are possible synergies between investors' interests and social ones is crucial. For example, improving working conditions can increase business productivity, and responsible economic activity can contribute to community well-being. The goal should therefore be to adopt a balanced approach, emphasizing the impact of sustainable investments on the real economy, **to highlight the synergies between entrepreneurship and the social economy** and incentivize the activities of economic entities towards a sustainable economy.

The central theme returns to the paradox that exists between a strictly prudential approach and an approach that takes into account the specificities of the social economy.

According to the classic (erroneous) interpretation, a business model guided by the principles of the social economy would be more exposed to social risks and therefore subject to more prudent capital reserves.

Such a model cannot reasonably be interpreted as "more" prone to risk. On the contrary, based on the characteristics and values represented, business models

oriented towards the social economy tend to operate in a safer financial context. Look at the Italian case to be taken as evidence and example.

Yet, despite the evidence, supervisory authorities have repeatedly considered socially oriented banks riskier than other models, due to the lack of understanding of their social and functional specificities.

It is believed to be of utmost importance that banks operating in accordance with the principles of the social economy (such as Italian BCCs) and thus social economy entities, be recognized as such, and that their business model be acknowledged within the framework of prudential supervision, in order to develop consistent supervisory policies and approaches, along with adequate tools to address them.

Question 13: Do you have comments on section 5.4 – consideration of ESG risks in internal culture, capabilities and controls?

We have no comments on this.

Question 14: Do you have comments on section 5.5 – consideration of ESG risks in ICAAP and ILAAP?

We believe it is appropriate and theoretically consistent to include ESG risks in the ICAAP and ILAAP processes, similar to how other risk factors are handled, without necessitating a separate index. This approach is furthermore consistent with the overarching approach that sees ESG risks influencing traditional risk categories.

However, we reiterate the epistemological problem raised in previous arguments regarding the difficulty in precisely defining the materiality concerning social risks. Please refer to the responses to questions 1 and 3 for further details.

Question 15: Do you have comments on section 5.6 – consideration of ESG risks in credit risk policies and procedures?

The guidelines entrust entities with the task of developing and implementing quantitative metrics for ESG-related credit risk. It is emphasized that, at least for the time being, there are insufficient definitions concerning the social sphere to allow for an assessment of the adverse impact of such risks on an entity's credit profile.

Once again, it is deemed challenging to determine materiality associated with social risks and, consequently, establish appropriate quantitative criteria and methods for evaluating their impact on the entity's credit risk.

These difficulties extend beyond social risks; all ESG-related risks pose challenges to integration into entity management processes due to numerous factors that must be considered and analysed to better define the guidelines. The main shortcomings are highlighted below.

- Insufficiency, incompleteness, and incomparability of ESG data: it is challenging to translate the available ESG data into expectations regarding the financial performance of a counterparty.
- Mismatch in time horizons: particularly concerning the materialisation of environmental risks, the difficulty of integrating ESG risks into credit risk policies and procedures emerges.
This is due to the discrepancy between institutions' strategic planning horizons and risk management frameworks, which are traditionally much shorter, and the time required to materialise ESG risks, which often develop over longer time spans.
- Non-linearity of ESG risks: this characteristic is linked to the unpredictability of generating environmental, geopolitical, social, and economic dynamics related to ESG factors.

It is considered imperative to address these challenges for a better integration of ESG risks into credit risk policies and procedures, as well as financial risks overall, aiming to enhance the long-term resilience and sustainability of financial institutions.

Question 16: Do you have comments on section 5.7 – consideration of ESG risks in policies and procedures for market, liquidity and funding, operational, reputational and concentration risks?

Please refer to the answer to Q15.

Question 17: Do you have comments on section 5.8 – monitoring of ESG risks?

We have no comments on this.

Question 18: Do you have comments on the key principles set by the guidelines for plans in accordance with Article 76(2) of the CRD?

Please refer to the answer to Q1.

Question 19: Do you have comments on section 6.2 – governance of plans required by the CRD?

In the Guidelines, paragraph 86 b), it is stated that for integrating ESG risks in the three lines of defense, regarding the second level, *the compliance and risk management functions should ensure that the risk limits set in the risk appetite statement as part of the risk management framework are consistent with all aspects of the institution's plan, including sectoral policies*. Since risk limits mentioned in paragraph 86 b) are usually monitored by the risk management function, we believe that reference to the compliance function can be removed.

Question 20: Do you have comments on the metrics and targets to be used by institutions as part of the plans required by the CRD? Do you have suggestions for other alternative or additional metrics?

We have no comments on this.

Question 21: Do you have comments on the climate and environmental scenarios and pathways that institutions should define and select as part of the plans required by the CRD?

We have no comments on this.

Question 22: Do you have comments on section 6.5 – transition planning?

We agree with the EBA regarding the importance for all financial entities to develop and implement a transition plan towards a more sustainable economy. This plan should clearly outline the internal processes used to prepare for such a transition and establish goals and milestones to be achieved.

However, we emphasize the importance of defining more explicitly how to coordinate and manage the integration of these transition plans with the increasing complexity and risk associated with the introduction of ESG factors into the prudential framework, as articulated in previous responses.

Furthermore, we highlight that in the current economic context, characterized by continuous evolution, it is essential to understand that ongoing transitions are not just two, but are articulated in three crucial areas: digital transition, green transition, and **social transition**. In particular, we emphasize the fundamental role of the social transition in the strategic planning framework. This component must be considered essential for the realization of a comprehensive, fair, and sustainable transition process.

Question 23: Do you think the guidelines have the right level of granularity for the plans required by the CRD? In particular, do you think the guidelines should provide more detailed requirements?

We believe that, regarding the environmental topics, current guidelines are quite comprehensive and provide a detailed framework for the planning required by the CRD. However, when it comes to the social and governance topics, there is still much work to be done. It is evident that the issues in these areas are complex and evolving, and therefore, it is essential for competent authorities to seek to create and coordinate incentives that are not contradictory. However, guidelines designed as such leave excessive room for discretion and do not allow for a clear determination of the scope and characteristics of the social sphere, which subsequently hinders the assessment of related risks.

For further considerations on this matter, please refer to the responses to Q1 and Q3.

Question 24: Do you think the guidelines should provide a common format for the plans required by the CRD? What structure and tool, e.g. template, outline, or other, should be considered for such common format? What key aspects should be considered to ensure interoperability with other (e.g. CSRD) requirements?

We believe that adopting a common format for plans required by the CRD could be a coherent step, provided it is implemented in accordance with the principle of proportionality and avoids a "one size fits all" approach.

However, before proceeding with such standardization, it is essential to address the existing issues highlighted in the responses to previous questions. In particular, we refer to the complexity in operationally assessing social risk and the evident paradox between the standard prudential approach, which tends to penalize riskier investments, and the need to orient transition plans towards a social and sustainable economy, which may involve an increase in the riskiness of investments in the social sphere.

Resolving these mentioned issues is crucial to enrich the dimensions through which risks are evaluated and, consequently, to formulate more proportionate and appropriate requirements. Therefore, before defining a common format, it is recommended to address these key issues to ensure a solid and coherent foundation for the subsequent development of guidelines.



Question 25: Where applicable and if not covered in your previous answers, please describe the main challenges you identify for the implementation of these guidelines, and what changes or clarifications would help you to implement them.

The main challenge to implementing the guidelines lies in overcoming the existing paradigm between **entrepreneurship and the social economy**, which influences investor choices seeking **a balance between financial risk and social merit**. It is crucial to address this issue and establish a clear and coherent direction that aligns with European principles while respecting the entrepreneurial principle underlying banking activity and the standard prudential approach.

The focus should center on two key words that should guide prudent analyses and assessments: "**intentionality**" and "**additionality**." This means that in evaluating an investment, an economic activity, or an exposure, it is essential to assess the purpose for which such activity was carried out. It is important to reward and recognize investments where intentionality toward declared social goals is acknowledged compared to other investments. For an entity and its investments to be considered "social," they must be openly oriented toward a social purpose (intentionality), with the direct goal of bringing social value, improving the economic conditions of a community, or similar (additionality).

It is reiterated that the prudential framework is currently not equipped to integrate the social factor within risk assessment parameters.

It is necessary to start from intentionality and the purposes of business actions to arrive at a social taxonomy and to succeed in achieving a coherent and clear definition and identification of the loss of value risk associated with social factors.

Question 26: Do you have other comments on the draft guidelines?

We have no comments on this.