E3G – Consultation response on EBA's draft guidelines on the management of ESG risks

Overall introduction and international developments

E3G welcomes EBA's work in defining guidelines on management of ESG risks and prudential transition plans. We consider relevant that financial institutions under the scope of the Capital Requirement Directive (CRD6) integrate forward-looking ESG risks considerations into their strategies, policies, and risk management processes. We also welcome EBA's effort in integrating appropriate time horizons into the prudential approach to transition planning. Adopting a long-term strategic thinking to risk management practices is a necessary step to ensure the climate resilience of the financial system.

We consider transition plans a strategic tool for companies to decarbonise and make their business model more risk resilient.[1] When combined with other tools such as sectoral pathways, taxonomies and technology roadmaps, transition plans can play an important role in accelerating and enabling the transition and decreasing long-term systemic risks, as well as attracting more investments. In particular, **the prudential exercise within the context of transition planning represents a fundamental risk management tool.** It is useful for financial institutions to manage (after having identified and measured them) strategic and financial risks stemming from their activities and exposures vis-à-vis the transition towards a sustainable economy.

This is why **we consider a complete separation of prudential and non-prudential transition plans an issue for the formulation of banks' transition plans**. Non-prudential transition plans under the Corporate Sustainability Reporting Directive (CSRD) and Corporate Sustainability Due Diligence Directive (CSDDD) are set to affect European financial institutions as well. Therefore, the distinction of prudential and non-prudential transition plans could translate into two heavily interconnected transition plans for financial entities.

Since transition plans can and should be used by a variety of user groups (including e.g. prudential supervisors) a centralised approach to transition planning could provide an overarching definition of transition finance and plans, encompassing both (i) corporate transition plans from real economy participants and (ii) prudential plans for financial institutions. At the international level, several initiatives are already pursuing a definition of a single transition plan framework which entails both corporate transition plan requirements and prudential (transition) plans. For instance, the Transition Plan Taskforce (TPT) has developed an approach defined as 'one transition plan, many uses'. While the Network for Greening the Financial System (NGFS) has published extensive research on a 'modular' transition plan guidance, i.e. applicable to non-prudential and prudential indicators alike.

General recommendations on EU policy approaches on transition finance, planning and plans

Our main recommendation is therefore to **keep climate mitigation strategy and risk management activities into one single consolidated plan**. Under EU law, non-prudential

[1] Transition plans are increasingly being recognised as strategic documents with a twofold objective: setting the target, finding tools and funds to achieve it, and planning for the transition while mitigating various emerging risks.

transition plans are defined under the CSRD, including its standards (ESRS). These are directly linked to the soon-to-be-finalised CSDDD. It's crucial to reiterate that **these non-prudential and mainly climate-mitigation-oriented transition plans contain also risk-management considerations**. The double materiality perspective enshrined in the CSRD (and CSDDD) not only analyses the impacts that companies and financial institutions have on people and the environment, but also considers the ESG-related financial risks and opportunities stemming from their business model. The risk perspective is therefore already present in the definition and methodology of non-prudential transition plans, notably the physical and transition risk components. The best way forward for further consolidating the EU transition finance framework is making sure that risk assessment under ESRS standard is seen, or becomes, the preliminary step for conducting a prudential analysis. In short, the prudential assessment should be considered as an additional section of the same plan. As mentioned in the EFRAG Materiality Assessment Implementation Guidance: "**Impact materiality and financial materiality are often intertwined**. The undertaking's impacts on people or the environment, combined with changes to strategy, including investments, as well as management decisions made to address such impacts may give rise to risks and opportunities. Material risks and opportunities generally derive from impacts and dependencies." This interlink should be better reflected by not requiring two separate outputs. Expanding the risk-management perspective in non-prudential transition plans with additional prudential-related measures would provide a much more complete instrument for the resilience and soundness of financial institutions' activities. This can be integrated into a single transition plan.

For these reasons, we believe that non-prudential and prudential transition plans should converge under the same 'umbrella' regulation of transition plans. We believe that a **single mandatory regulatory framework for transition plans in the EU is of utmost necessity to ensure regulatory coherence and streamline transition planning behaviour.** This framework should apply to financial and non-financial companies alike and include financial risk management obligations that are currently set out in prudential plans. Mainstreaming and aligning transition requirements across relevant pieces of EU legislation would help companies effectively design and implement plans, support financiers in more effectively considering companies' progress in their financial decisions and portfolios and ensure coherence in overall approach to the plans.

General recommendations on ESG risk assessment and management

The link between sustainability factors and financial stability risks is well established within the EU's sustainable finance agenda. Thus, we welcome the EBA efforts towards better assessing and managing those risks. The main (but not only) transmission channel for such risks are stranded assets. Investments in assets that might rapidly lose value, such as those related to fossil fuels, are a financial stability risk because the sudden loss of asset value might lead to contagion in the financial system.

The impact of sustainability risks on the financial value of assets therefore justifies making capital requirements sensitive to sustainability risks, either in minimum capital requirement rules (Pillar 1), at the level of individual financial institutions' governance and risk management (Pillar 2) or at the very least through increased transparency about who holds these assets (Pillar 3). There are strong arguments to recognise climate risks across all three pillars of the prudential framework, including when setting capital requirements under Pillar 1. In this regard, some actors have called for a "one for one" approach, which would mean that for every euro that insurers and banks invest into new fossil fuel-related activities, they should have one euro equivalent of their own funds to guard against risks of stranded assets and related future losses. Although there are no harmonised EU capital requirements for pension funds, supervisory practises can, to a certain extent, apply a similar intervention logic. Raising capital requirements under this precautionary approach would ensure investors properly account for the full costs, impacts, and risks of environmentally harmful activities, which are incompatible with the EU climate objectives. This would correctly price the risks of financing unsustainable projects, therefore making fossil fuel-related investments less profitable and less market-viable.

Considering the above, higher capital requirements need to be considered for fossil fuel-related assets held by banks as a first important step to properly account for climate and sustainability risks. This precautionary approach is only a first step and would have to be complemented by a range of other measures taken to improve incorporation and assessment of climate risk across all three pillars of the prudential framework (for example, by requiring disclosure of transition plans under Pillar 3).

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?

We agree with the EBA's assessment that to ensure financial stability, financial institutions (particularly those considered systemically important) must approach transition planning with a thorough understanding, assessment, and management of risks arising from their activities. This includes aligning with regulatory sustainability objectives and broader transition trends toward a sustainable economy. We agree with EBA's assessment that "plans under non-prudential regulations, such as CSRD and CSDDD, focus on the compatibility of business models of undertakings with the 1.5-degree pathway and the objective of the EU to achieve net-zero greenhouse gas emissions by 2050". We agree that financial institutions under the CRD6 scope must outline in their transition plans how they intend to identify, measure, manage, and monitor ESG risks as part of their strategic response to the transition.

However, we disagree on two interpretations:

- The differentiations between prudential (CRD6) and non-prudential plans (CSDR and CSDDD)

- Consequently, the differentiation between the plan alignment vs nonalignment with EU policy objectives.[2]

Firstly - regarding the differentiation between non-prudential and prudential transition plans in paragraphs 11-19 - we believe that also financial institutions under the CRD6 scope should ultimately develop a single plan, integrating both prudential and non-prudential objectives, requirements, and use cases. By consolidating prudential and non-prudential approaches under the same umbrella of an overarching, and modular transition plan, we could ensure alignment across the several requirements, avoid fragmentation whilst simplifying the adoption, disclosure, and implementation of such plans. A single plan would avoid fragmentation not only among decision-makers & supervisory authorities (EU Commission, EBA, EIOPA, ECB, etc.) but also within financial institutions under the scope of the CRD6. One plan would mean less administrative burden, a clearer and single strategy, and more consolidation among risk managers and financial professionals working on risk and target setting. One modular plan would mitigate industry resistance and transform transition planning into a unique strategic decision-making and risk management tool, rather than merely a compliance exercise. Consolidating transition plan requirements within a single document would benefit the private sector by removing duplications and additional reporting burdens. Moreover, streamlining the process in one document would support the forward target setting of the entity by incorporating both risk and impact considerations. Having a single final output could position the EBA Guidelines as specifying prudential requirements and expectations that financial institutions should incorporate into their overarching transition planning process and resulting transition plan.[3] Moreover, this approach could serve as a model for other international jurisdictions, bridging the gap between prudential and non-prudential discussions on transition plans at international level.

Secondly, regarding the possible nonalignment of prudential plans with policy goals – we believe this would create inconsistencies across the overall objective of the EU transition. The focus on the compatibility of business models of undertakings with the 1.5-degree pathway should not be only for CSRD and CSDDD, but also an ultimate prudential goal. Indeed, nonalignment contributes to the accumulation of financial and climate risks, bringing to a higher systemic likelihood of disorderly transitions and increased physical risks. This should not happen for various reasons:

- The IPCC in its Sixth Assessment Report noted that climate-related risks are higher than previously assessed, and that "*climatic and non-climatic risks will increasingly interact, creating compound and cascading risks that are more complex and difficult to manage*".
- The IMF noted in December 2023 that an orderly transition to net zero by 2050 could result in global gross domestic product being 7 percent higher than under current policies.
- BCBS Chair Pablo Hernandez de Cos said that "climate-related financial risks…are perhaps the most existential medium-term threat to the global banking system."

---

[2] From EBA's consultation paper: "*These guidelines do not require CRD-based plans to set out an objective of fully aligning with Member States or Union sustainability objectives or one specific transition trajectory.*"

[3] It is very helpful to clearly distinguish between any guidance relating to the **process of *transition planning*** and the **static (but iteratively updated) *transition plan***, as proposed by the NGFS in its 2023 Stocktake on Financial Institution's Transition Plans

Failing to align prudential considerations with climate policy goals only poses an additional systemic risk: the alignment itself should be seen as a systemic risk mitigation tool. Considering the prudential approach of transition planning, target setting should be considered a unique decision of the single plan, with misalignment causing a decrease of the risk management and mitigation quality. Indeed, a bank that is not aligned only causes systemic risks (see above) but also faces increased transition risks itself (including arising litigation risks).

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.

EBA consideration of environmental, social and governance risks takes an interpretation of 'impact materiality' that is slightly different from the CSRD/ESRS definition. According to Paragraph 26 of section 3.5, EBA defines '*environmental and social materiality*' as the situation in which '*economic and financial activities of counterparties or invested assets can have a negative impact on environmental and social factors, which could in turn translate into financial impact on the institution*'. However, 'impact materiality' is to be considered from an 'inside-out' perspective, in which an entity's operations or exposure can negatively affect the people and the environment, as considered under CSRD. The translation of impacts into financial risks for the entity falls under the 'financial materiality' definition, the other aspect of the double materiality approach. This EBA's framing of 'impact materiality' could create two separate interpretations of 'double materiality' and create potential regulatory inconsistencies at EU level. As such, we suggest aligning the 'impact materiality' definition with the CSRD/ESRS counterpart. This includes not only modifying its description in the EBA draft guidelines, but also renaming the 'environmental and social materiality' into 'impact materiality'.

The EU Taxonomy was conceived as an impact-based tool and not a risk-assessment tool. However, the do no significant harm (DNSH) 'oath' of the European Green Deal is a principle that can mitigate risk interactions across the various environmental objectives of the Taxonomy (i.e. climate mitigation & adaptation, biodiversity, water, circular economy, etc.). Further working on the **DNSH principle's application in public and private investments is a way forward to help financial institutions determine their exposure to transition risks, and how to handle interactions between various types of risks**. Banks could be looking at whether companies they are investing in are complying with the DNSH criteria. The ones that do not comply, would be the most likely to be exposed to transition risks.

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

We agree that the prudential approach to risk management should mostly consider the financial materiality perspective. We therefore recognise that financial institutions under the scope of

CRD6 would perform a materiality assessment focused on the financial risks stemming from their activities and exposures.

However, we would like to express the following recommendations:

- We suggest to explicitly state which kind of materiality assessment is needed under CRD6. In case it follows a financial-materiality-only approach, we recommend highlighting that such 'single materiality' approach under CRD6 would align as much as possible with the existing financial materiality perspective of non-prudential (corporate) transition plans (under CSRD/ESRS). In this way, **the prudential-focused financial materiality assessment would be coherent and expand on existing EU guidelines from the non-prudential counterpart.**
- Regarding the technical wording, we suggest aligning the financial materiality definition under the EBA consultation with the one present in the CSRD/ESRS. Specifically in Paragraph 15, under section 4.1, we suggest modifying the wording 'likelihood and severity of the materialisation of the risks' with 'the **likelihood** of occurrence and the potential **magnitude** of the financial effects.'

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.

We believe that requiring a 'high level' of alignment with the EU Taxonomy is a relevant step forward. However, this step is not complete for the reasons outlined below:

- It does not specify what a 'high level' is exactly: a quantitative measurement would be required to make it objective and measurable
- More importantly, whatever figure is used to define a "high level", the EU taxonomy criteria alone will not be enough without reaching a 100% alignment, because that the sector could still include activities that do not comply with the DNSH criteria, hence being environmentally harmful. An example is the exposure of a power generation company 70% taxonomy aligned. In this case, the remaining 30% could be environmentally harmful (e.g. coal-fired plants), therefore potentially creating transition risks. This issue of environmentally harmful activities should be considered in a risk-based approach, as a relevant proxy.
- We believe that to create a more robust proxy for non-materiality, the additional criterion for nonaligned activities is the compliance with DNSH.
- Such compliance is already required to companies and banks assessing their taxonomy alignment (i.e. alignment with substantial contribution criteria and alignment with DSNH criteria). Therefore, this would not represent an additional burden, and simply needs to be disclosed by the banks who wish to have a derogation from paragraph 16 on the materiality assessment for transition risks (bearing in mind that it does not work for physical risks, as clearly mentioned in the document)

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.

For net zero scenarios, EBA consultation refers only to the IEA Net Zero Emissions' scenario. While this approach as welcomed, potential granularity issues should be consider4ed as well. Additionally considering NGFS and/or the NZBA scenarios (the latter is still in progress) could be beneficial.