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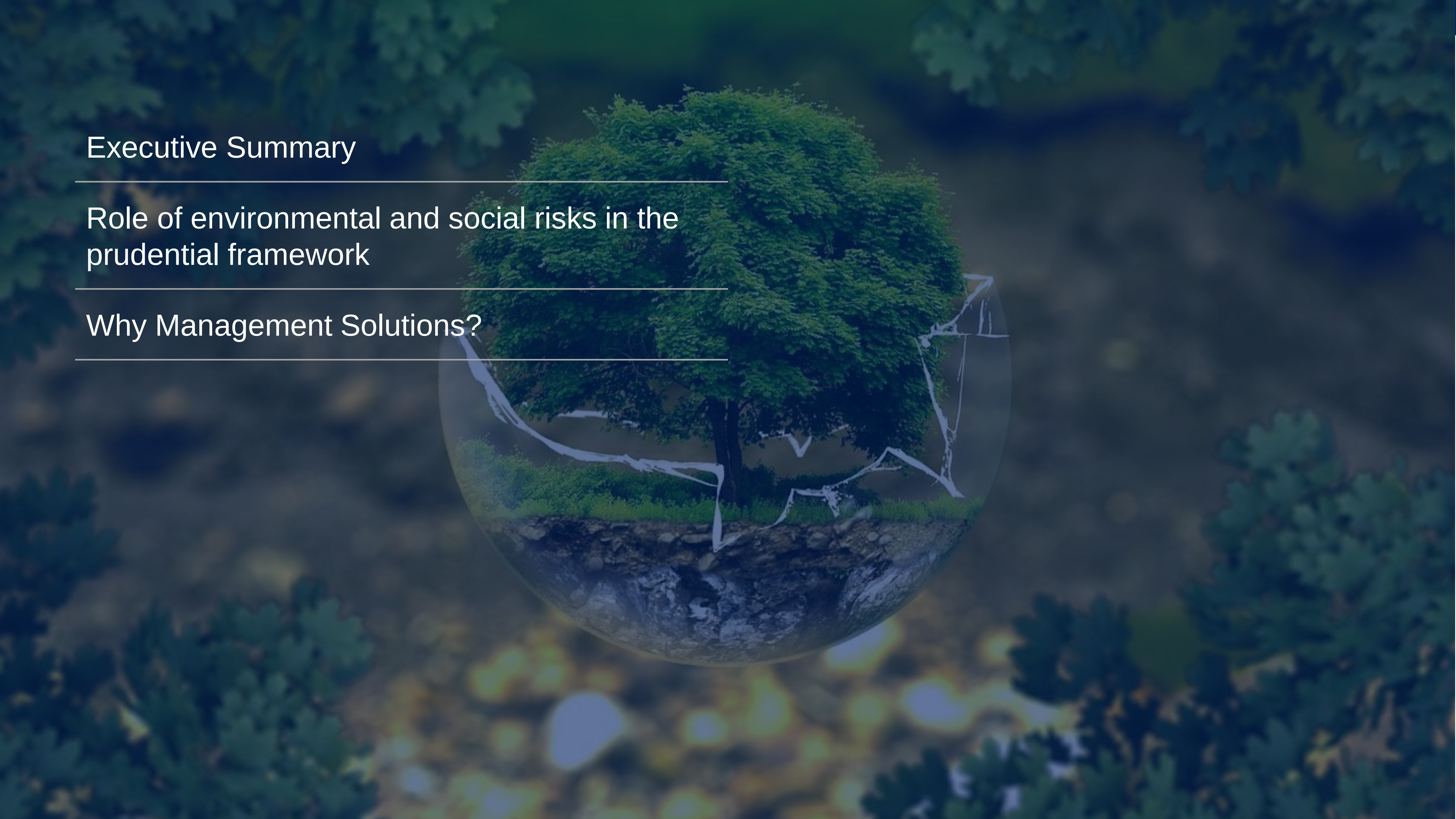
Making things happen

EBA Report on role of environmental and social risks in the prudential framework



1 Executive summary

EBA has published a Report on the role of E&S risks in the prudential framework to accelerate the integration of E&S risks into Pillar 1 through specific short, medium and long term actions

Regulatory context

- CRR3 contains a **mandate** for the EBA to develop a **report assessing the prudential treatment of exposures to E&S factors**.
- The EBA Discussion Paper published in 2022 initiated the discussion on the appropriateness of the current Pillar 1 framework to address **environmental risks**.
- The Report on the role of environmental and social risks takes the **Discussion paper as a starting point** to introduce short term and medium to long term actions for financial institutions.

Next steps

Alongside other policy initiatives outside the prudential framework, **EBA will continue to strengthen the integration of E&S risks across all pillars** of the regulatory framework.

Short term actions

Recommendations for **actions to be taken over the next three years** as part of the implementation of the **CRR3/CRD6.**

- Include environmental risks as part of **stress testing programmes** under both the **internal ratings-based** (IRB) and the **Internal Model Approaches** (IMA) under the **Fundamental Review of the Trading Book** (FRTB).
- Encourage inclusion of E&S factors as part of **external credit assessments** by credit rating agencies.
- Encourage the inclusion of E&S factors as part of **due diligence requirements** and **valuation of immovable property collateral.**
- Require institutions to identify whether E&S factors constitute **triggers** of **operational risk losses**.
- Progressively develop environment-related **concentration risk metrics** as part of supervisory reporting.

Medium to long term actions

Possible **revisions of the Pillar 1 framework** reflecting the growing importance of E&S risks:

- The possible use of **scenario analysis** to enhance the forward-looking elements of the prudential framework.
- The role of **transition-plans** as part of the development of further **risk-based enhancements** to Pillar 1 framework.
- Reassessing the appropriateness of the **IRB supervisory formula** and the **standardised approach** (SA) for credit risk to better reflect environmental risk elements.
- The introduction of **environment-related concentration risk metrics** under the Pillar 1 framework.

Access to document

Role of environmental and social risks in the prudential framework

Key aspects

In its work, the EBA considers a number of premises and principles, as well as the main challenges that should be considered when assessing E&S risks

Objective

- **Addressing evolving risks**: respond to the consequences of climate change, biodiversity loss and other E&S concerns.
- **Adapting prudential framework:** assess the need for specific clarifications to account for E&S risk drivers in risk management.
- **Supporting sustainable transition:** mitigate risks arising from ESG factors while ensuring the overall financial stability.

Background and rationale

- **Emerging risks:** acknowledge the increasing challenges leading to heightened physical and transition risks for financial stability.
- **Role of financial sectors:** manage E&S risks as sources of financial risk materialising through traditional prudential risk categories.
- **Report scope and approach:** clarify the prudential framework, focusing on elements affected by environmental risk drivers.

Principles and premises

- **Risk based approach:** to assess the justification for dedicated prudential treatment of exposures related to E&S objectives. The focus is on exploring specificities in risks to adjust prudential treatment while maintaining safety, soundness, and financial stability.
- **E&S risks as drivers:** institutions can be impacted by E&S factors through their core business activities, influencing exposures to counterparties and invested assets.

  Considering **double materiality** to recognise the dual impact of institutions on E&S risks and vice versa through fully controlled activities and core business activities. Institutions should consider the economic and financial activities of counterparties and invested assets in relation to E&S risks for financial performance and solvency.

Challenges

- **Data availability and measurement challenges:** data gaps, lack of standardised classifications, and difficulties in linking forward-looking ESG information to prudential parameters. Availability of relevant and high-quality data, remains a significant challenge.
- **Estimation of losses due to E&S risks:** historical data and market prices may not fully reflect E&S risks, posing challenges in quantifying the extent of impact on capital levels.
- **Time horizon considerations:** potential mismatch between the time horizon of the Pillar 1 framework and the long-term manifestation of environmental risks poses a fundamental challenge. As **challenge in the estimation of systemic risks**, if E&S risks will grow the overall systemic risks or lead to a re-profiling of risk between sustainable and unsustainable sectors.

2 Role of environmental and social risks in the prudential framework

Key aspects: points of attention (1/3)

Credit risk – Standardised appoach	**Institutions**	• It is recommended that **external credit assessments** integrate E&S factors as drivers, wether relevant. Although further assessment on the **robustness of the methodologies,** the level of **transparency and disclosure** to the public is needed. • **Verification** by Competent Authority (CA) that **due diligence requirements explicitly integrate environmental aspects** to ensure that environmental risks are appropriately captured and reflected in the prudential framework whenever relevant.
	EBA	• **Monitor** that **financial collateral valuations** increasingly reflect environmental factors, in the **medium to long term.** • Assess whether **high-quality specialized lending corporate exposures** (introduced in CRR3) **could be subject to similar environmental provisions as under the infrastructure supporting factor** (ISF), where only exposures meeting strong environmental standards may benefit, in the **medium to long term**. • **Reassess** whether environmental risks should be considered in evaluating the **appropriateness of risk weights** assigned to **real estate exposures** and how can be reflected in the **prescribed risk weights in STA**, in the **medium to long term**.
Credit risk – Internal ratings-based approach	**Institutions**	• E&S risks should be considered in the **rating assignment** (e.g. risk differentiation step), **risk quantification** (e.g. MOCs, downturn component, calibration segments) and in the **application** (e.g. human judgment and overrides)**,** in the **short term**. • **Reflect** E&S risks in their **PD** and **LGD estimates** through a re-development or recalibration of their rating systems in the **long term** (once the impact of E&S risks on default and loss rates become available). • **Consider** E&S risks as part of their **stress testing programmes** in the **short term.**
	EBA	• Need for **guidance on data collection** regarding potential **E&S risk** drivers to benefit institutions in **designing rating models**. • **Assess** whether relevant **E&S risk drivers** should be added to the **existing lists of risk drivers** mentioned in the EBA GL on PD and LGD estimation and the treatment of defaulted exposures, in the **medium to long term**. • **Premature** to consider **further differentiation** in the **RW supervisory formula,** the **RWs** applied to specialised lending under **slotting approach** and **F-IRB parameters**. The EBA will **reassess the appropriatenesss in the medium/long term.**

Main challenges in the short term

2 Role of environmental and social risks in the prudential framework

Key aspects: points of attention (2/3)

Credit risk – collateral valuations	Institutions	• Account for **relevant environmental factors** in the prudent valuation of immovable property collateral, in the **short term.** • **Adjust** the **current market value** of the collateral when does not adequately **address the relevant risks** associated with environmental factors, in the **short term**. Covering **valuation at origination, re-valuation and monitoring**.
	EBA	• **Monitor how ESG factors** are reflected at **collateral value**, considering the national specificities.
Credit risk – Adjustment factors	EBA	• **Does not recommend** introducing adjustment factors related to environmental risk drivers, at this stage. • Reassess if and how **environment-related adjustment factors** could be taken into account as part of a **prudentially sound** and **risk-based prudential treatment** of individual exposures, in the medium to long term.
Market risk	Institutions	• Consider environmental risks in their **trading book risk appetites**, **internal trading limits and new product approvals**, in the **short term.** • Consider environmental risks in their **stress testing programmes by IMA instutions,** in the **short term.** • CA should assess how **ESG-linked products** are treated in relation to the **risk-residual add-on** to ensure **harmonised treatment** across institutions and how they are treated in the **internal risk measurement model**, in the **medium/long term.** • Consider **ESG risks** when monitoring risks that are **not included** in the model. ECB' **RNIME[1] framework** could be used.
	EBA	• Reassess the appropriateness of **including** under the **sensitivity-based method (SbM) a dimension**, in the equity and credit-spread risk classes, reflecting ESG risks to establish the buckets into which a **risk factor falls**, or of including an environmental risk class, in the medium to long term. • Reassess the appropriateness of introducing **regulatory provisions** explicitly requiring institutions to capture material environmental risk drivers in their **internal models**, in the medium to longer term.

Main challenges in the short term

[1] RNIME: risks not in the model engines

2 Role of environmental and social risks in the prudential framework

Key aspects: points of attention (3/3)

Operational risk	**Institutions**	• **Identify** whether E&S constitute **triggers of operational risk losses,** in the *short term*.
	EBA	• Reassess the appropriateness of revisions to the **BCBS SA methodology** based on the evidences of E&S risk drivers may **trigger operational losses** in increased frequency and severity.
Liquidity risk		• At this stage, the EBA **does not recommend** changes to the **LCR and NSFR framework.**
Concentration risk	**EBA**	• Definition of **environment-related concentration risk** (e.g. exposures to counterparties/issuers, supply chain risk events…) • Development of **exposure-based metrics** for the quantification of environment-related **concentration risks,** in the short term. Implement those metrics as part of supervisory reporting. • Consider an **improved concentration risk metric**, in the medium/long term. • Reassess introducing **environmental-related concentration risks** under the **Pillar 1 framework**, in the medium/long term, including the design of **limits and thresholds**, **add-ons or buffers**, and **consequences** if there are breaches.
Capital buffers	**EBA**	• The **systemic risk buffer** (SyRB) appears as the **most relevant tool to address environmental risks within the current macroprudential framework**. The EBA will assess the need for **changes to its guidelines** on the appropriate subsets of sectoral exposures to which a SyRB may be applied, in the short term. • Coordinate with other ongoing initiatives to address environmental risks, in the medium to long term.
Investment firms	**EBA**	• **Treatment** of E&S risks remain under the **Pillar 2 framework** for all **K-factor**s including those related to **Risk to Client** (RtC), in the short term. EBA **does not recommend** changing the **prudential framework**, in the short term. • Extending the **potential changes** of CRR framework to the investment firms' prudential framework at medium/long term.

Main challenges in the short term

Management Solutions has been involved in several projects in the area of ESG integration in risk management

Proven ESG experience

Extensive experience in the field of **ESG risk management** in **large financial institutions, and non-financial sector companies**. We offer services in all areas of sustainability risks with a **360º vision** (further detail in next slide).

Experience in the field of integration of ESG factors in risk management

Extensive experience in the **field of risk in projects in different areas** such as materiality assessment, risk appetite, *risk identification and assessment,* limit setting, implementation of regulatory requirements in credit- granting and monitoring , collateral management, stress testing exercises, (both supervisory - ECB climate ST/ ST PRA - and internal)....

Extensive knowledge and experience in the field of capital

Deep knowledge of capital as a result of collaborations with the main **European G-SIBs and D-SIBs**. Reference consultant with supervisors, with 7 framework agreements, including support to the inspections in the capital area (+ 130 missions).

ESG Data

Holistic view of the ESG reporting model to cover both regulatory requirements (e.g. Pillar 3 ESG, ECB climate ST...) and management requirements (e.g. annual report, sustainability reporting, green finance reporting...).

Benchmark capability

***Benchmarking* capacity** in the field of ESG and specifically in the integration of ESG factors in risk management as a result of extensive **experience in various financial institutions in Europe and America, having carried out more than 100 projects.**

Expert team

Expert sustainability team with **extensive experience in regulatory requirements, supervisory expectations and market best practices.**

3 Why MS?
ESG credentials by line of activity

Management Solutions has a working group of experts that supports its clients in the implementation of their environmental and social risk framework in each of the 6 defined lines of activity, providing expertise in each business area

MS capabilities in sustainability by line of activity

1 Strategy, Governance and Culture

- Diagnosis, strategic framework and general action plan.
  Framework definition: Governance, methodologies, reporting.
  Change Management: Project Management (PMO), Regulatory Observatory, Training.

2 E&S measurement methodologies

- Quantification of physical and transition risks through scenario analysis, Impacts on stress test, CO2 footprint, portfolio alingment and target setting, AI use cases in Sustainability, validaiton of ESG models, TNFD aligment, social impact, third party rating, in-house tools development

3 Sustainable business development

- Definition of taxonomy and marking of of sustainable operations according to international standards.
  Market diagnosis and analysis.
  Design of sustainable business strategies (industries, products, services).

4 Risks

- Integration in risk appetite, admission and monitoring, ESR rating, collaterals value, ESG risk measurement in the supply chain,…

5 Data and Technology

- Requirements and definition of the ESG and climate risk reporting model.
  Definition of the metrics and KPIs model.
  Functional and technological architecture.
  Analysis of alternatives (supplier vs. internal).
  Implementation.

6 Reporting (internal and external)

- Double materiality, aligment with CSRD, Pillar 3, SFDR, EU Taxonomy and local regulation, ESG dashboards, definition and implementation of reporting models, governance and data quality mechanisms,…

Portfolios

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