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Draft Guidelines on the management of ESG risks

EBA´s consultative document highlights


ESG

EBA has published a Consultation Paper Draft Guidelines on the management of ESG Risks to set up the preliminary requirements for institutions

Objective	• Define the **requirements for institutions** for the **identification, measurement, management and monitoring of ESG risks**, including through **plans** aimed at addressing the risks arising from the **transition towards an EU climate-neutral economy**.
Calendar	• **Public hearing** on the consultation paper on **28 February 2024** • Comments' **submission** until **18 April 2024** • **Expected final guidelines by the end 2024. Application: TBC** (aligned with the amended CRD6 application date)
Scope	• **Requirements for environmental**, **social and governance risks. Extending environmental beyond climate**-related ones, such as risks stemming from **degradation of ecosystems and biodiversity loss**, as well as of other ESG factors[1]. • Applicable to **all institutions including SNCI[2]**, considering the **proportionally** criteria and covering their **material ESG risks**. • **Cover all material subsidiaries in and outside of the EU**, by having regard to applicable local legislation and ESG regulatory objectives. • **Proportionality** criteria based on size and internal organization, and the nature, scale and complexity of their activities, when developing and implementing the approaches for ESG risks management[3].
Main challenges	• Assessment and monitoring of **ESG risks** over institutions' **exposures/assets** in different **time horizons** and **climate scenarios through…** o Exposure method to obtain a short-term view of how **ESG risks are impacting the credit risk profile and the profitability of counterparties** (embedding in **KRIs, internal credit scoring or rating models or valuation of collateral**, when it is applicable). o Portfolio-based & Scenario-based methods to support the **medium-term planning process** and to define **risk limits**, **appetite and EWIs** steering the institution towards its strategic objectives and assess their **sensitivities to ESG risks** in different time horizons. • **Data collection** related to **ESG factors at least for large corporates** based on client engagement approach to gather it (onboarding or periodic reviews), public information or external providers. Possible application of estimation/proxies to be reduced progressively. • **Portfolio alignment & transition plan:** setting of **targets at least for the most climate contributing sectors,** as well as definition and monitoring of **transition plan** leveraged on embedding in **lending policies, new product offering, client engagement tools**…

1. Annex 1 of EBA Report on management and supervision of ESG risks
2. Small and non-complex institutions.
3. Title I of the EBA guidelines on internal governance. Paragraphs 17 & 18.
4. Early Warning Indicators

Access to Document

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Calendar

January 2024	*February 2024*	*April 2024*	*December 2024*	*January 2025*	*June 2025*
Publication of **new Guidelines on the management of ESG Risks (Draft)**	Public hearing on the consultation on **28 February**	The **deadline** for the **submission** of comments is **18 April.**	Publication of **Final Guidelines on the management of ESG Risks**	**Expected application of CRR3 from 1 January 2025**, with certain elements of the regulation phasing in over the coming years	**Amendment of the CRDVI** expected to be **transposed by member states by mid-2025**.

EBA is **consulting on the draft guidelines for a period of three months**. Feedback from the public consultation will be taken into account when finalising the guidelines. It is planned that the **guidelines** will be finalised **by end-2024** and **apply from [tbc – depending on CRD6 application date]**

2 EBA requirements
Key aspects (1/4)

EBA CP Draft Guidelines on ESG Risks management is split by three building blocks: i) reference methodology for identification and measurement of ESG Risks; ii) minimum standards and reference methodology for the management and monitoring of ESG risks; iii) Plans in accordance with CRD6

i) Reference methodology for identification & measurement of ESG Risks

Materiality

- Execution of **materiality assessment of ESG risks at least annually** (every 2 years for SNCI) to ensure that ESG risk identification and measurement are integrated into their strategies and internal procedures. To be included in ICAAP.
- **Covering all financial risk categories** (credit, market, liquidity, operational, reputational, business model, and concentration) and **highly climate contibuting sectors[1] at short, medium and long term.**
- Include **qualitative and quantitative data and ESG assessment of impacts** on the most significant **activities, services and products** (considering the climate risk drivers under different climate scenarios)
- Use of **risk-based approach** that considers the **likelihood and the severity of the materialisation of the risks**.

Identification & Measurement

Data processes

- **Implementation** of **systems to collect and aggregate ESG risks-related data across the institution** as part of the overall data governance and IT infrastructure (including arrangements to assess and improve ESG data quality)
- **Capture of data** for the assessment of the **current and forward-looking ESG risk profile** of **counterparties** (at least for large corporates), including **client and asset-level data**. Data collection from onboarding or periodic reviews or external sources[2]. Examples:
  - i. for **environmental**, emissions, material impacts on climate and biodiversity, dependency on fossil fuels energy and water demand, EPCs, forward-looking adaptive capacity such as transition plans, etc.;
  - ii. for **social and governance risks:** compliance with and due diligence on social standards, governance practices,…

Methodo-logies

Combination of three methodologies to assess ESG risks across time horizons, supported by **Key Risk Indicators:**

- **Exposured-based:** assess the exposure of their counterparties' activities and key assets to ESG factors (including risk factors and mitigants). Considering ESG factors into overall assessment of default risk of a borrower and, where justified by their materiality, embedded in the risk indicators, internal credit scoring or rating models, as well as the valuation of collateral.
- **Portfolio-based:** use of at least one portfolio alignment methodology to assess the degree of alignment of institution's portfolios with climate-related sustainability targets. Measuring the gap between existing portfolios and benchmark scenarios and its financial impacts[3].
- **Scenario-based**: perform climate/environmental scenario-based analyses.

1. Sectors listed in Sections A to H and Section L of Annex I to Regulation (EC) No 1893/2006.Exceptions may be considered if it is justified by institution.
2. Where data from counterparties and public sources is not available, institutions should have remediating actions (e.g. estimations/ or data providers)
3. List of sectors with portfolio alignment required: power; fossil fuel combustion; automotive; aviation; maritime transport; cement, clinker and lime production; iron and steel, coke, and metal ore production, chemicals.

2 EBA requirements
Key aspects (2/4)

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ii) Minimum standards and reference methodology for the management and monitoring of ESG risks

ESG risks management principles	• Embedding **of ESG risks within the regular risk management framework, systems and processes** ensuring consistency with the overall business and risk strategies, including policies and limits. • **Manage and mitigate ESG risks** over the short, medium and long term through **risk management tools.** • Tools should be considered, among others, **engagement** with counterparties, **financial or conditions terms or pricing** adjustments, ESG embedding within **global, regional and sectoral risk limits, diversification** of lending portfolios or financing reallocation to better ESG profiles.
Strategies & Business Models	• Consider **ESG risks** when **developing and implementing business and risk strategies**. • Understand how **ESG risks can impact** the **company's business model** and its **strategic objectives.** • Formulating and monitoring **ESG risk-related strategic objectives** and related **Key Performance Indicators** based on insights **from portfolio alignment, environmental scenario analyses and stress testing.**
Risk appetite	• Clearly define **all material ESG risks** to which the institution is exposed and the type and extent that it is **willing to assume**. • Set **risk appetite** and associated **KRIs** are appropriately **cascaded down** within institution, including limits, thresholds and exclusions. • At least consider **metrics listed by EBA** with backward-looking and forward-looking views.
Internal culture, capabilities & controls	• Clear **communication from the management** body (‘tone from the top’) and appropriate measures to **promote knowledge of ESG factors** and risks **across the institution**, as well as **awareness** of the institution’s **ESG strategic objectives and commitments.** • Ensure, through training policies, that management body and staff are **adequately trained** to understand implications of **ESG factors.** • Embed ESG risks into **internal control frameworks** across the **three lines of defense** with a clear definition and assignment of responsabilities and reporting lines.

EBA requirements

Key aspects (3/4)

EBA CP Draft Guidelines on ESG Risks management is split by three building blocks: i) reference methodology for identification and measurement of ESG Risks; ii) minimum standards and reference methodology for the management and monitoring of ESG risks; iii) Plans in accordance with CRD6

ii) Minimum standards and reference methodology for the management and monitoring of ESG risks	
ICAAP/ILAAP	• **Material effects of ESG risks** to be embedded in ICAAP and ILAAP considering appetite, thresholds and limits set for material impacts to **identify and measure internal capital needs.** • Include in the ICAAP a **forward-looking** view of institution's capital adequacy **under an adverse scenario** that includes environmental elements specifying any changes to their business plan derived from climate risk stress testing, in line with EBA Stress Testing Guidelines[1].
Credit risk policies & procedures	• Embedding **in credit risk policies** to ensure clear **processes to identify, measure, manage, mitigate and monitor** impacts from ESG. • Implement **quantitative credit risk metrics** covering most significant client segments, type of collaterals and risk mitigation instruments. • Ensure that **credit sectoral policies,** reflecting ESG risks, are **cascaded down** to business lines and business relationships officers.
Other risk policies	**Assess current and potential future** ESG-related impacts on **market, liquidity & funding, operational, reputational & concentration risks**: • **Market**: how ESG risk affect the **value of the financial instruments,** evaluate the **potential risk of losses and increased volatility in their portfolio's value,** and establish effective processes to control or mitigate the impacts. • **Liquidity**: how ESG risks affect **net cash outflows** or the value of assets comprising their **liquidity buffers** and, where appropriate, incorporate these impacts into the calibration of their buffers or risk management framework. Also assess the **availability and stability of funding sources** at different time horizons and normal/adverse conditions (including potential impacts of ESG reputational risks). • **Operations: how ESG risks affect regulatory risk event types** and the potential impacts on **conduct risks, litigation and reputational risk** related to **lending and investing** in business which may be prone to **ESG-related controversies**. • **Concentration:** assess of **shares of exposure affected** relative to total & if ESG-related concentration **aggravates its financial vulnerability**.
Monitoring	• **Monitor** ESG risks on a **continuous basis** through **internal reporting framework** to senior management, implementing a granular monitoring of counterparties, exposures and portfolios. Include ESG factors in **regular credit reviews for medium-sized and large counterparties**. • Set **Early Warning Indicators** and **backward & forward-looking ESG risk metrics** such as historical losses related to ESG risks or share of income stemming from business with counterparties that contribute to climate change.

1. EBA Guidelines on institutions stress testing (EBA/GL/2018/04). Paragraph 90.

2 EBA requirements
Key aspects (4/4)

EBA CP Draft Guidelines on ESG Risks management is split by three building blocks: i) reference methodology for identification and measurement of ESG Risks; ii) minimum standards and reference methodology for the management and monitoring of ESG risks; iii) Plans in accordance with CRD6

iii) Plans in accordance with Article 76(2) CRD6

Key principles

- Institution's **transition plan** should **address and mitigate** the portfolios and exposures **materially exposed to ESG risks**, covering those that **highly contribute to climate change** (Sectors A to H, plus L) unless institution may provide an appropriate justification.
- Ensure that **short, medium and long-term objectives and targets interact and are well-articulated,** including long-term objectives translate into medium-term strategies and that short term financial metrics or targets are consistent (e.g. profitability indicators, cost of risk, …)
- **Transition plan** should be properly reflected in **risk appetite** (PIA[1], limits) aligned with business strategy in different time horizons and their **internal capital needs**, considering potential deviations over planned trajectory under adverse scenarios.

Governance

- **Roles & responsibilities:** assign ESG responsibilities at 3LoD. Approval/oversee of plan implementation by management bodies.
- **Internal process and capacity:** regular **interaction** at **all levels of the organization** to ensure that insights and feedback from internal stakeholders. Ensure **sufficient capacity, expertise and resources** to develop, implement and monitor their transition planning process, identifying existing gaps in skills and expertise and take **remedial actions where necessary**.

Metrics, Targets & Climate scenarios

- **Set and monitor the targets with cascade these down to the sectoral/portfolio levels** at least for the **materially exposed sectors and portfolios** more subject to these risks (different time horizons and **applying scenarios and patways consistent across the organization**).
- **Use of metrics:** financed GHG emissions, portfolio alignment metrics, climate-related income, energy efficiency of real estate collateral and % counterparty engagement on sustainable economy. **Also require** other metrics to assess the **resilicience to physical risk**, management of **nature and biodiversity-related risks**, **ESG-related concentration and reputational risks**.

Transition Planning

- Clearly lay out **processes** and implement **objectives and targets for transition** such as integrating ESG factors in loan origination policies, changes in strategic financing choices or development of new products or services.
- Define **data processes** to collect verify and aggregate data needed to **formulate and monitor transition plans.**
- **Client engagement** through tools such as reviewing counterparties ESG risk profile and transition plans and actions to promote the client transition through adjusting product offering or agreements to enhance the counterparty's transition.
- Assess the **implications of transition process** (e.g. revenues impact) and **align the financing activity evolution** with **risk management policies.**

1. Profitability impact assessment.

Key aspects and differential value

Management Solutions has an expert working group that supports its clients in the implementation of their sustainability framework within each of the 6 defined lines of activity, bringing expertise in each business area

MS capabilities on sustainability

1 Strategy, Governance and Culture

- Diagnosis, strategic framework and general action plan.
- Definition of the Framework: Governance, methodologies, reporting.
- Change Management: Project Management (PMO), Regulation Observatory, Training.

2 Methodologies for measuring climate risks

- Implementation of climate risk measurement methodologies.
- Scenario analysis and evaluation of the impact on the portfolio.
- Climate stress test exercises, Regulatory – ECB, BoE) and Internal. Integration in ICAAP
- Financed emissions calculation and alignment to NZBA

3 Sustainable business and Social Impact

- Taxonomy definition and marking of sustainable operations according to international standards.
- Social Impact measurement methodologies
- Market diagnosis and analysis.
- Sustainable business strategy design (industries, products, services).

4 Risks

- ESG risk management.
- Integration of the ESG dimension within the Risk Appetite, Credit Risk (admission and monitoring, models, pricing...), Operational Risk (continuity plans), Market Risk and Liquidity.

5 Data and Technology

- Requirements and definition of the ESG information model.
- Metrics model definition and KPIs.
- Functional and technological architecture.
- Analysis of alternatives (Vendors vs. in-house).
- Implementation

6 Reporting

- Analysis of information requirements (CSRD, Pilar 3, TCFD, GRI Standards, GHG Protocol + Local regulation and best practices).
- Definition and implementation of reporting models.
- Governance and mechanisms data quality.

Business

- *Retail*
- *Customer*
- *Companies and Markets*
- *Management of Assets*
- *Insurance*

Key aspects and differential value

Management Solutions has been involved in several projects related to ESG embedding into risk management

Proven ESG experience

Extensive experience in the field of **sustainability and climate and environmental risk management** in **large financial institutions, non-financial sector companies and the World Bank**. We offer services in all areas of sustainability and climate risks with a **360º vision** (framework, governance, organisation, methodologies, management processes, tools, data and reporting).

Extensive experience in the field of risk management

Extensive experience in projects in different areas such as risk appetite, risk identification and assessment, limit setting, implementation of regulatory requirements in the granting and monitoring of credit, collateral management, regulatory stress testing exercises, ...

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

Proven experience in the integration of ESG factors in credit risk management based on the several projects undertaken: definition and implementation of the target operating model of integration in the management of ESG factors, materiality analysis, development of ESG policies, embedding of KPIs ESG in strategical plans, risk appetite and portfolio management, development of ESG assessment workflow of clients, climate stress testing exercises (EBA Climate data, ECB & PRA Climate ST)

ESG data

Holistic view of the ESG reporting model to cover both regulatory requirements (e.g. Pillar 3 ESG, ECB climate ST, CSRD...) 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 credit management as a result of extensive **experience in various financial institutions in Europe and America, having carried out more than 200 projects.**

Specialist team

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

A

Annex 1
Data requirements

Environmental risks	Social & Governance risks
• **Geographical location of key assets and exposure** to environmental hazards (e.g. floods, water stress, soil erosion)	• **Compliance with and due diligence on social standards** (ej. ILO conventions or World Bank's Environmental and Social Standards)
• **Current & forecasted GHG scope 1, 2 and 3 emissions** in absolute and/or intensity such as per million-euro revenues or per units of production	• **Governance practices**
• **Material impacts on the environment,** including **climate change and biodiversity**, and related **mitigation or adaptation policies**	• **Adherence to voluntary or mandatory social and governance reporting**
• **Dependency on fossil fuels**, either in terms of economic factor inputs or revenue base	• **Negative impact on local communities,** including due diligence policies to prevent that
• **Energy and water demand and/or consumption**, either in terms of economic factor inputs or revenue base	• **Litigation risks including imminent, pending or completed litigation** case related to social or governance issues and due diligence policies
• **Energy performance certificates** and score in kWh/m² for real estate	
• **Adherence to voluntary or mandatory climate/environmental reporting**	
• **Litigation risk including imminent, pending or completed** litigation case related to environmental issues	
• **Forward-looking adaptive capacity,** including transition plans prepared by non-financial corporates	

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A | Annex 2

List of metrics (1/2)

Metrics of Plans in accordance with Article 76(2) CRD6 (to be considered for risk apettite)
• **Financed GHG emissions** by scope 1, 2 and 3 emissions split by sectors (absolute emissions and intensity of emissions, relative to revenues or units of production)
• **Portfolio alignment metrics** (projections and (mis)alignment with a pathway consistent)
• **Amount and/or share of income** related to business with counterparties operating in **sectors that highly contribute to climate change**
• Breakdown of **real estate portfolio by energy efficiency level**
• **% counterparties** with whom the institution **actively engages** regarding **adaptability and resilience to the transition** to a sustainable economy
• **% positive outcomes** with whom the institution **actively engages** regarding **adaptability and resilience to the transition** to a sustainable economy
• **Other metrics** to support risk assessment and strategic steering related to: (i) **resilience to physical risk;** **(ii) management of environmental risks** other than climate-related (**nature and biodiversity);** **(iii) ESG-related concentration risks;** **(iv) ESG-related reputational risk**

Risk appetite
Metrics & targets

Annex 2

List of metrics (2/2)

Monitoring Indicators
• **Historical losses and forward-looking estimate(s) of exposures-at-risk and (potential) financial losses** related to ESG risks
• **Amount and share of income** (interest, fee and commission) stemming from business relationships with counterparties **operating in sectors that highly contribute to climate change**
• **Gap between existing portfolios vs benchmark portfolios** consistent with the **climate target applicable**
• **GHG financed emissions,** at least for sectors towards which the institution has material exposures
• **% counterparties** with whom the institution has **engaged on ESG risks** matters, supplemented with the **results and/or outcomes of such engagement**
• **% environmentally sustainable exposures financing activities** that contribute or enable the objective of **climate change mitigation vs total exposure** • **% carbon-intense exposures** over total institution's exposures Also for **large institutions**: ○ **% Taxonomy-aligned exposures for other objectives of the EU Taxonomy vs total exposure** ○ **% exposures detrimental** to the achievement of these objectives For exposures detrimental to the objective of biodiversity, assess material negative impacts of their counterparties' production sites, processes or products on biodiversity.
• **Concentration risk related to physical risk drivers** (e.g. measurement of exposures and/or collaterals in high flood risks or wildfire risks areas)
• **ESG-related litigation claims** in which the institution has been, is or may become involved
• **Progress against all institution's targets** set in relation to ESG risks and ESG objectives

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International *One Firm*
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Proven Experience
Maximum Commitment

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