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AIMA Response to EBA "Discussion Paper on management and supervision of ESG risks for credit institutions and investment firms"

The Alternative Investment Management Association (AIMA)[1] is grateful for the opportunity to respond to the European Banking Authority's (EBA's) discussion paper on managing and supervising environmental, social, and governance (ESG) risks at credit institutions and investment firms. Many of our members are exploring the integration of ESG factors into their investment and risk management processes; some have already implemented rigorous ESG policies and practices.

We welcome the EBA's decision to propose a proportionate approach to regulation in this area. Given the complexity of the issues involved, and the endless ways in which ESG issues interact with individual investment strategies, a proportionate approach is the best way to encourage the integration of ESG factors across the investment management industry. Creating unduly prescriptive frameworks—especially around internal governance—may dissuade some investment managers from integrating ESG into their investment and risk management processes.

At the moment, many ESG standards are geared towards the long-only equity investment industry, which is dominated by a handful of very large firms. As such, those standards are often premised on an assumption that the parties affected will have large numbers of staff and significant levels of assets under management, will invest in corporates, and will hold their investments indefinitely. This is not the case for the alternative investment management industry. While our members are dedicated to managing ESG risks to their portfolios, they can be hampered by regulation designed

[1] AIMA, the Alternative Investment Management Association, is the global representative of the alternative investment industry, with more than 1,900 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2 trillion in assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 170 members that manage $400 billion of private credit assets globally. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors). For further information, please visit AIMA's website, www.aima.org.

for a separate industry.

The most important step regulatory authorities can take to foster ESG integration is to ensure that investment managers have access to consistent, thorough, and timely ESG data from issuers. We strongly recommend that regulators increase ESG disclosure requirements for issuers before taking any steps to mandate ESG protocols for investment managers. Armed with the necessary data, investment managers can then take the steps they deem necessary to manage the ESG risks to which they are exposed.

Finally, we would stress the need for consistent regulation. In order to avoid undue difficulties and confusion, any new proposals should fit within the framework of the existing regulations on sustainable finance; most notably, the Sustainable Finance Disclosure Regulation (SFDR).

The cause of ESG integration would be best served by regulators focusing on enabling investment managers to integrate ESG factors into their processes in a manner that makes sense for their businesses and their investment strategies, rather than mandating a uniform approach to such a complex, nuanced topic.

We would be happy to elaborate further on any of the points raised in this letter. For further information please contact Max Budra, Associate, Markets, Governance and Innovation (mbudra@aima.org).

Yours sincerely,

/s/

Adam Jacobs-Dean
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AIMA

ANNEX

Discussion Questions

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

   The Sustainability Accounting Standards Board (SASB) is a very popular tool amongst our members; it is often used to map the ESG factors that are investment material for different assets.

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

   We have no objection to either definition.

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.**

   We have no objection to this understanding of ESG risks from a prudential perspective.

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

   We have no objection to either definition.

5. **Please provide you 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 have no objection to either definition.

   We would, however, note the interaction of governance factors with environmental and social risks. While poor governance on the part of a counterparty will likely exacerbate their vulnerability to environmental and social risks, robust governance should mitigate that vulnerability. Prudential regulation should recognise this reality and make allowances for investment managers working to improve the governance of counterparties. For instance, even if the counterparties—and thus the environmental and social risks—remain the same, regulators should not treat two loans the same if one loan includes governance covenants and the other does not.

   The ongoing COVID-19 pandemic has served to highlight the materiality of certain ESG factors. Some issuers, for instance, have suffered adverse financial impacts after their purportedly subpar workplace safety practices have been made public. The stated intention of many jurisdictions—including the European Union, the United States of America, and Canada—to include environmental considerations in their COVID-19 relief plans has also served to augment the perceived materiality of environmental factors, from both a risk and a reward perspective.

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 have no objection to the description of liability transmission risks, nor do we object to the notion that such risks could be occasioned by social or governance factors.

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 provided are generally acceptable for investment firms.

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

8. **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 have no objection to the steps identified in the paper.

9. **Please provide your views on the relevance and use of qualitative and quantitative indicators related to the identification of ESG risks.**

   Quantitative and qualitative indicators can be used to identify ESG risks, although such identification is easier for some risks, and some assets. As the EBA notes, ESG data is generally still poor: there are large coverage gaps, and ESG data providers often rely heavily on subjective judgements in creating scores. A significant amount of ESG data is only updated quarterly, or even annually, as it is dependent on issuers' public releases. Further, as the EBA notes, many ESG risks are novel, and thus particularly difficult to measure and predict.

   This complicates the use of ESG data for alternative investments. ESG data tends to be most robust for large corporate issuers that are headquartered in developed markets and traded on public markets. Data for smaller issuers, or issuers based in developing markets, tends to be sparse; this is doubly true for private markets. Further, the annual nature of some ESG data can make it difficult to accurately gauge ESG risks, as such risks could significantly increase or decrease in less than a year.

   In short, investment managers require thorough, robust ESG data across asset classes in order to properly gauge ESG risks. We would strongly urge the EBA to ensure that such data is available before mandating the use of ESG data by investment managers.

10. **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.**

    N/A

11. **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.**

    While portfolio alignment has been discussed in the alternative investment management industry, it remains rare, as alignment analyses are difficult and resource-intensive, and most alternative investment managers do not have the resources necessary to conduct them.

12. **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.**

    As with portfolio alignment analyses, climate stress testing is complex and resource-intensive. As such, most—if not all—alternative investment managers will not have the resources necessary to conduct such tests.

    Climate sensitivity analyses, however, may become more common in the future. Such analyses are, as the EBA notes, less resource-intensive, and do not rely on long-term modelling. For instance, an alternative investment manager could analyse their portfolio's sensitivity to a carbon tax, or to a natural disaster. Again, however, we would stress that such analyses are only beginning to be considered, let alone implemented. Furthermore, such risk management techniques do not need require a new regulatory framework, as existing regulatory requirements already encourage investment managers to conduct such analyses if appropriate.

13. **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.**

    The exposure method is by far the most common means of gauging ESG risk in the alternative investment management industry. Alternative investment managers are increasingly purchasing ESG data from third parties to gauge their exposure to material ESG risks. Such information allows managers to limit their exposure to undesired ESG risks both at the asset level—by substituting assets or engaging with issuers on their ESG practices—and at the portfolio level, for instance by using short positions to offset their ESG exposures on their long books.

    There are, however, multiple challenges with this approach. First, as mentioned above, ESG data can often be inconsistent, or simply absent, especially for alternative asset classes. In general, issuer-level ESG disclosures requirements are still relatively lax. Second, ESG data can often be subjective, and it is not always easy to learn how ESG data providers create their final scores. Third, when investing in green bonds and similar products, it is not always clear whether investment managers should be measuring the ESG scores of the projects being financed, or of the issuers themselves.

Ensuring that ESG data is reliable, consistent, and widely available is arguably the most important single thing regulators and authorities can do to help the management of ESG risks in the financial sector. This will allow investment managers to make well-informed decisions on ESG risks. Indeed, the availability of such data may render specific ESG risks regulations unnecessary, as investment managers will naturally take steps to limit their exposure to undesired ESG risks once they can be reliably identified.

14. **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.**

    N/A

15. **Specifically for investment firms, do you apply other methodological approaches, or are the approaches described in this chapter applicable also for investment firms?**

    Alternative investment managers have a powerful tool for managing ESG risks not mentioned in the EBA's paper: the ability to sell assets short. By using short positions, alternative investment managers can hedge against ESG risks. For instance, an alternative investment manager could limit their overall exposure to carbon risk by offsetting their long exposure to carbon emissions with short positions. For a more detailed explanation of how such a risk management process could work, please see the AIMA paper 'Short Selling and Responsible Investment.'[2]

The management of ESG risks by institutions (Chapter 6)

16. **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.**

    We agree that smaller institutions can be vulnerable to ESG risks, and we welcome the EBA's acknowledgement that any response to that reality should be proportionate.

17. **Through which measures could the adoption of strategic ESG risk-related objectives and/or limits be further supported?**

    As stated in our answers to previous questions, the greatest challenge to the management of ESG risks is the lack of quality ESG data. The most important step regulators can take to further the adoption of ESG risk management is making ESG data more widely available, more comprehensive, and more consistent. Regulators should begin by increasing disclosure

[2] https://www.aima.org/sound-practices/industry-guides/short-selling-and-responsible-investment.html

obligations for issuers, before taking any actions to encourage the adoption of ESG risk-related objectives.

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

    Alternative investment management firms have a long history of innovation and will act to integrate ESG risks into their processes and strategies whenever material. Despite their small size, alternative investment management firms are taking steps to improve the ESG performance not just of their portfolios, but also of their management companies.

19. **Please provide your views on the proposed ways how to integrate ESG risks into the internal governance of institutions.**

    Given their small size, alternative investment managers tend to have relatively flat organisation hierarchies. As such, it is difficult to make any recommendations on how ESG risks could be integrated into their internal governance, as the internal governance of every alternative investment manager is different. Again, we welcome the EBA's acknowledgement of the need to be proportionate in this area.

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

    As active risk managers, alternative investment management firms take a holistic view of material investment risks, including next order drivers of risk. As such, we do not believe that it is necessary to create extra regulations specifically for ESG risks. Indeed, the argument could be made that by doing so, regulators would run the risk of divorcing ESG risk management from the traditional risk management function, thus creating a false distinction between ESG risks and 'traditional' investment risks.

21. **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.**

    Governance risks have always been integral to alternative investment managers. Indeed, many alternative investment managers generate their returns by improving the governance of their portfolio companies. As such, we do not believe that additional guidance around governance risks is necessary for our industry.

    With regards to social risks, the major obstacle is again data. Social risks are arguably the hardest ESG risks to measure; doing so in an objective manner is doubly difficult. Any consideration of social risks would need to begin by addressing this fundamental issue. We urge regulators to work together to craft consistent definitions and metrics for social issues, and to ensure that data on those metrics is available.

Finally, we would note that environmental risks are not always simple or easy to gauge. While it may be relatively simple to gather data on, say, carbon emissions by large corporate issuers, other environmental issues, such as land degradation or the use of plastics, tend to be less well-documented. Furthermore, the management of climate risks is exceptionally complicated, especially when it requires medium-to-long-term climate change modelling.

22. **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.**

    For alternative investment managers, the key risks manifest at the portfolio level. Given their small footprints, alternative investment managers do not require extensive ESG risks mitigation at the corporate level, nor do they require extensive governance arrangement to deal with such risks. At the portfolio level, alternative investment managers already consider all material risks to their investments. As such, we urge regulators to ensure that investment managers have the tools to perform their tasks. Specifically, alternative investment managers require high-quality ESG data.

    ESG factors and ESG risks in supervision (Chapter 7)

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

    Private credit managers involved in direct lending are subject to the SFDR, and as such are already required to identify and measure certain ESG risks in their portfolios. The Alternative Credit Council, the global representative body for the private credit industry, would welcome the opportunity to discuss these matters with the EBA.

24. **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.**

    N/A

25. **Please provide your views on the incorporation of ESG risks considerations into the assessment of the credit institution's internal governance and wide controls.**

    N/A

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

    N/A

27. **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 applaud the EBA's incorporation of proportionality into their paper, and we urge all regulators to keep the principle of proportionately in their minds when creating regulation in such a dynamic area.

28. **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?**

    N/A