FIA EPTA response to the EBA Discussion Paper on management and supervision of ESG risks for credit institutions and investment firms

3 February 2021

Introduction:

The FIA European Principal Traders Association (FIA EPTA) represents 30 independent European Principal Trading Firms (PTFs) that deal on own account, using their own money for their own risk, to provide liquidity and immediate risk-transfer in exchange-traded and centrally-cleared markets for a wide range of instruments, including shares, options, futures, bonds and ETFs.

As market makers and liquidity providers, our members contribute to efficient, resilient, and high-quality secondary markets that serve the investment and risk management needs of end-investors and corporates throughout the EU. Our members are active participants on almost all European exchanges and platforms. Moreover, our members are important sources of liquidity for institutional investors accessing liquidity pools across Europe. FIA EPTA supports transparent, robust and safe markets with a level playing field and appropriate regulation for market participants.

In 2019 FIA EPTA established a Sustainable Finance Committee for its member firms to explore how liquidity providers can contribute to the green transition. It is FIA EPTA's view that sustainable finance offers a great promise in unlocking investment capital that is essential for fighting climate change and mitigating its impact for citizens. To be widely accepted by investors, sustainable finance products need to be embedded in a healthy secondary market environment which ensures liquidity and enables investors to risk-manage their exposures.

FIA EPTA conducted a survey amongst its membership in June 2020 on the engagement of principal trading firms with Sustainable Finance and ESG initiatives. The FIA EPTA survey found that 76% of responding FIA EPTA members consider it important to provide liquidity in ESG related products. 46% of the respondents are already providing liquidity in ESG products and 81% are expecting to expand or to start with liquidity providing in such products. FIA EPTA is committed to supporting policymakers in ensuring the success of the sustainable finance project at all levels of the capital market ecosystem. We would welcome the opportunity to provide further background information to the European Banking Authority (EBA) on these and the other issues raised in our response.

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

Question	**FIA EPTA response**
14. Specifically for investment firms, do you apply other methodological approaches, or are the approaches described in this chapter applicable also for investment firms?	FIA EPTA members are market makers and providers of liquidity enabling risk management for market participants. This means that FIA EPTA members use their own capital to buy and sell financial instruments for their own risk. Contrary to other investment firms, FIA EPTA members do not manage funds for third parties (hence they do not have clients, only counterparties). The consultation that the EBA has published mainly focuses on ESG risks stemming from clients and counterparties. This means that the ESG risks outlined by the EBA apply to a limited extent. We would like to highlight that FIA EPTA members' trading counterparties are regulated firms. This means that they operate according to the necessary industry standards, including minimised risks stemming from ESG. As our members only have counterparties, the approach that our members use can be best described as the exposure method. Before counterparties become an actual counterparty, they are screened and evaluated. In this process, a counterparty is, where deemed appropriate, screened on various risks, including ESG risks. Examples of screening elements are money laundering, reputation, governance (does the counterparty hold the necessary licenses?). Screening is typically done in-house, but external resources like the use of specialised sustainability rating agencies (SRA's), ESG evaluations of credit rating agencies, or ESG scoring models could be used in addition to this. Depending on the outcome of the assessment a counterparty is onboarded, rejected, or further investigated. The other methodological approaches for assessing and evaluating ESG risks (portfolio alignment method and the risk framework method) imply that an investment firm would need to invest on behalf of third parties. As FIA EPTA members do not manage funds for third parties or have clients, this means that our

	members do not make use of such methods. For the same reason, ESG indicators such as the EU taxonomy are not considered to apply to our members. To conclude, FIA EPTA members deal with regulated parties as counterparties, perform additional screenings that may already include the necessary ESG elements, and do not have clients or manage funds, but trade on their own account and at their own risk. That said, any additional regulatory ESG risk management frameworks would be an unnecessary burden and not proportionate to the business model of FIA EPTA members and similar investment firms.

Chapter 6: The management of ESG risks by institutions

Question	FIA EPTA Response
21. 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.	**Business strategies** FIA EPTA members do not have portfolios of retail and corporate loans and do not take deposits. FIA EPTA members are independent investment firms that provide liquidity in various asset classes. Market makers ensure that other market participants find sufficient liquidity to execute their trades. As such, FIA EPTA members do not take directional positions but stand ready to transact in order to facilitate the investment and risk management activities of other market participants. In doing so the market maker accumulates an inventory and will try to hedge such inventory resulting in a balanced portfolio. FIA EPTA members have therefore a limited exposure to ESG risks in their portfolios. **Risk management framework** Internal governance is also usually more simple and proportionate to the scale and complexity of the business. Principal trading firms may or may not have a dedicated risk management function which may be held by any senior officer such as COO and may or may not have a risk committee or an internal audit. Principal trading firms deal with a variety of counterparties: • Trading counterparties (i.e. those firms actively seeking liquidity from FIA EPTA members and trading with them) where exposure to that counterparty only exists when a member enters into a trade with that counterparty and ceases when that trade settles;

	• Those directly related to trading such as exchanges, clearing members and executing brokers that are regulated and may be subject to stricter disclosures requirements or may even disclose voluntarily ESG metrics; • Other services providers relating to ancillary support services that are usually smaller in size, private companies, not regulated and likely to be less advanced in their green transition. IF do not have exposure in their balance sheet arising from these counterparties other than a debt arising from the outstanding payment and potentially an operational risk component should the service be critical and fail. The existing risk management framework is based on risk-based controls although they do not refer specifically to ESG risks. However, they do not prevent relevant ESG factors and ESG risks to be taken into account to the extent they have a material impact on Investment Firms business models. Furthermore, as recognised in the Discussion Paper, not all investment firms are impacted the same and therefore it should be left to the investment firm to assess the materiality of the ESG risks arising from its activity and how to best deal with it within the investment firms existing risk management framework (such as the risk appetite and the annual risk assessment). FIA EPTA members, therefore, support a principle-based approach that would require ESG factors to be reflected in the overall risk framework but without setting prescriptive requirements. In terms of assessment of ESG risks of counterparties, investment firms should be able to rely on the disclosures made by their counterparties when such disclosures are available. For those counterparties that may not disclose ESG metrics (e.g. those that are non-regulated and less advanced in their green transition), it would not be practicable, not to say disproportionate, to ask an investment firm to assess the ESG risks of every counterparty. Investment firms may not have the necessary business relationship to access ESG information or data from these counterparties as disclosures obligations currently only apply to a selected type of market participants mostly asset managers and listed companies. Therefore, it should be left to the investment firms to determine how to approach the ESG risks of its counterparties provided it can explain the main method used to engage with its counterparties and the reasons why, based on a general understanding of the business model, it believed or had reasons to believe that such counterparty may or may not be subject to ESG risks that could materially impact the investment firm. To the extent that the service is critical for the investment firm, ESG considerations could also be integrated into the existing requirements on critical outsourcing.

	Governance Investment firms are managed by a board of directors and based on the size and complexity of the business model do not usually warrant committees or specific governance programs. Understanding ESG risks of counterparties and ESG risks of the investment firm's operating environment should be an integral part of good governance. In terms of governance standards, the management body of investment firms have in general, under local company law framework, obligations toward their shareholders and the company itself. They also have regulatory obligations, such as the obligation to hold sufficient financial resources and not to cause harm to the market. These obligations are already well defined, and they inherently include the assessment, monitoring and mitigation of direct (the firm) and indirect (the firm's counterparties) ESG risks should they be relevant and material. In summary, although FIA EPTA members support the expectation of regulators to see investment firms integrate ESG factors in risk management and governance processes, we believe that the existing framework (being the regulatory framework, company law framework or similar regulations) is currently adequate to allow the integration of ESG factors. The methodology to assess ESG risk of counterparties should not be prescriptive and should be proportionate to the size and nature of the activity of the investment firm, including the size, location, and sector of the counterparties of such investment firms. Notwithstanding this, FIA EPTA members support the recommendation in the Discussion Paper to incorporate ESG risk-related considerations in directives and regulations (that we believe should not be limited to the banking sector but, in order to promote a standardised approach, should be applied across the whole value chain). In particular to include in the provisions on governance and risk management the requirements to reflect ESG factors (to the extent material) and to establish and implement a long-term resilient business strategy.

Chapter 7: ESG factors and ESG risks in supervision

Question	**FIA EPTA Response**
25. Please provide your views on the incorporation of ESG risks considerations in the assessment of risks to capital, liquidity and	**Environmental considerations**: with climate change impacting global supply chains through altered growing seasons to disrupted power supplies, volatility is on the increase.

funding.	• as liquidity providers/market makers, FIA EPTA members are particularly exposed to diminishing liquidity during increased volatility making it more challenging to fulfil our commitments to maintaining orderly and liquid markets. • Sustained volatility leads to increased margin requirements putting financial pressure on FIA EPTA member firms and reducing the ability to deploy liquidity thereby further increasing volatility and consequentially risk. Incorporating Environmental risk considerations should be conducted with sensitivity to increasing capital requirements to finance FIA EPTA members' ongoing liquidity provisioning. FIA EPTA members believe that it is highly likely that regulators will be seeking specific consideration of environmental risks as part of the stress testing firms are having to undertake as part of the new IFRS 9 capital planning requirements. However, with regard to sensitivity, changes to margin/finance requirements must be proportional and guidance would be useful. **Social considerations**: the commodity markets are particularly exposed to challenges regarding socially responsible practices. • Cocoa, Coffee and other agricultural commodity markets are particularly exposed to challenges from the wider stakeholder communities about the mistreatment and financial disadvantages to growers. Which can create reputational contagion for market participants. This is an area that FIA EPTA members would support thoroughly and would support increased transparency to allow all member firms to be aware of their exposure to contagion risk when supporting markets with social practices that are not in line with UN SDG 10. It is important to note that a rapid withdrawal from these markets could have very undesirable effects and a transitional period would require support from market makers and liquidity providers. **Governance considerations**: FIA EPTA members are committed to ensuring the operation of orderly markets. Our commitment is aligned with UN SDG 10 for reducing inequality within and among countries and specifically Target 10.5: Improve the regulation and monitoring of global financial markets and institutions and strengthen the implementation of such regulations.

26. 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.	As referred to in our response to Q21, FIA EPTA members believe that it is key that a proportional approach is adopted to achieve the desired aim of requiring investment firms to manage and minimise risk due to the impact of ESG factors on their counterparties. Dependent on the level of exposure to a counterparty, it should be open to firms to adopt a measured risk-based approach rather than an overly prescribed approach that results in a level of administrative burden which is unwarranted given the risk exposure to that particular counterparty. As FIA EPTA members are market makers and liquidity providers, the vast majority of the counterparties which members deal with are trading counterparties whereby the risk exposure to those counterparties is temporary in nature. The risk exposure exists from the point of execution of a bilateral (non-CCP cleared) trade with that counterparty until the trade settles i.e., usually within 2-3 days (T+2 being the standard settlement cycle). FIA EPTA members believe that it should be left to the investment firms to integrate ESG factors into their existing counterparty risk review processes and to take these into consideration where appropriate given the level of exposure to the class/type of counterparty.