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DISCUSSION PAPER ON MANAGEMENT AND SUPERVISION OF ESG RISKS FOR CREDIT INSTITUTIONS AND INVESTMENT FIRMS

CONTACT NAME

Matteo Riccardo Oldani

Avantage Reply

Via Castellanza, 11
20151 - Milano - ITALY
mobile: +39 348 5105647
e-mail: ma.oldani@reply.it

TEAM MEMBERS

Oksana Sisterhenn

Avantage Reply

21-25 Allée Scheffer
L-2520 - Luxembourg - LUXEMBOURG

Christopher Posvar Rossi

Avantage Reply

Via del Giorgione, 59
00147 - Roma - ITALY

Audrey Weber

Avantage Reply

Nova South
160 Victoria Street, Westminster
London SW1E 5LB – UK

Vishwas Khanna

Avantage Reply

Nova South
160 Victoria Street, Westminster
London SW1E 5LB – UK

Hadrien Van Der Vaeren

Avantage Reply

Nova South
160 Victoria Street, Westminster
London SW1E 5LB – UK

Sebastien Gillet

Avantage Reply

Congresstraat / Rue du Congrès 5
1000 - Brussels – BELGIUM

Giorgio Pavia

Avantage Reply

Via Castellanza, 11
20151 - Milano - ITALY

ANSWER TO EBA DISCUSSION PAPER

Hereinafter, we report our answers that we have given to a subset of the questions reported on EBA Discussion Paper on Management and Supervision of ESG Risk for Credit institutions and investment firms.

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

In our capacity as consultants advising banks under the EBA jurisdiction, we help to address clients' needs while relying on the following frameworks in addition to the framework already provided by EBA we use:

- The United Nations Sustainable Development Goals (SDGs).
- The Sustainability Accounting Standards Board (SASB).

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

We believe that the definitions of ESG Risk should be expanded to include the own activities of institutions. For example, the damage that physical risk could do on own critical infrastructure for the business continuity.

Question 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

From a prudential perspective, focusing on the negative impacts of risk factors is, in our opinion, appropriate and consistent with the approach taken for other risks. However, we believe it would be helpful to clarify that this should not be construed as limiting the ability of credit institutions to recognise the potential positive impacts of risk factors when undertaking a comprehensive evaluation (e.g. in stress testing).

Question 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.

We believe that the taxonomy used should be consistent across investment firms and credit institutions, because a single group can contain both. How these risks are transposed into KPIs, measurement methodologies etc. would vary depending on the specific circumstances driven primarily by the materiality.

In our experience, investment firms (and investment banks) are mainly exposed to the same risks as credit institutions (e.g. market risk, counterparty risk). One risk that is more specific to investment firms is fiduciary risk. This risk can be defined as the risk of losses for the firm due to the fact an agent will not act in the client's best interest. The existing proposal could be applied to fiduciary risk by looking at how ESG risk materialises itself through fiduciary risk.

Question 8. Please provide your views on the relevance and use of qualitative and quantitative indicators related to the identification of ESG risks

We thank the EBA for the summary of the challenges faced by institutions on this topic.

Some of the elements cited are inherent to the topic (e.g. level of uncertainty and time-horizon mismatch). As such, we suggest:

a) In addition to the suggested indicators and metrics, the EBA could provide methodologies and data sources to help institutions. In the past, the EBA did this with the IRRBB guidelines (EBA/GL/2018/02) in Annex I and Annex II. Another example is the Climate Financial Risk Forum of the FCA which provides a practical guide.
b) Regarding insufficiency of data, we would propose that European Supervisory Authorities (ESAs) would work together with IFRS or other reporting entities to construct a European and / or international database adopting new technology available such as Blockchain, etc.
c) Regarding the multi-point impact, one approach could be to continue to recognise ESG risk as an element inside each of the traditional prudential risks (as you propose in paragraph 34). However, firms should assess the overall impact using specific metrics that aggregate the impact across prudential risks.
d) The proposed metrics do not currently mention assessing the risk-adjusted return by taking into account ESG risks. It could be a useful addition.

Question 15. 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

In our capacity as consultants, we have worked with smaller institutions on ESG risks, more specifically climate change. From this experience, we recommend that smaller institutions assess their vulnerability to ESG risks; however, this assessment should be proportionate with an initial focus on identifying if the risk could be material.

Examples of why this risk could be material are due to credit risk concentration to industries that could be particularly impacted by climate change (e.g. aviation). Another possible material risk for smaller firms are mortgages concentrated in areas that are more exposed to climate change (e.g. flooding).

Question 17. Please provide your views on the proposed ways how to integrate ESG risks into the business strategies and processes of institutions

We believe that it is correct that ESG factors and risks should be integrated into Business Strategies, Business Model and Business processes. In particular, we agree on the need to define, monitor and report the following items to the supervisory authority:

1) The impact of changing business environments and long-term resilience on the market via the integration of ESG factors and risks.
2) ESG risks addressed as strategic objectives with considerations relating to the Risk Appetite Framework.
3) The volume of ESG oriented products developed or available in the Credit and Investment Institution or Portfolio (in coherence also with the disclosure required by SFDR).

Given the upcoming EBA task on ESG disclosure, any reporting requirements might need to be reviewed to align them with the disclosure obligations, to ensure coherence and to consider proportionality and data available as well as to reduce the burden on banks.

Question 18. Please provide your views on the proposed ways how to integrate ESG risks into the internal governance of institutions.

We believe that the EBA should consider mentioning Enterprise Risk Management (ERM) as an approach to manage ESG risk. The ERM approach would utilize competent resources throughout the firm, specialized in different topics, and allow the interpretation and mitigation of ESG risks within a complete picture.

To support this proposal, we can refer more broadly to Insurance Core Principle #16, which was also highlighted in the Bank of International Settlements Nov. 2019 policy paper entitled "Turning up the heat."

Question 19. Please provide your views on the proposed ways how to integrate ESG risks into the risk management framework of institutions

Financial institutions are likely to already mitigate ESG risks through their processes like loan origination, mortgage valuation, etc. For example, by assessing flooding risk when providing a mortgage. Thus, it is critical to ensure that the ESG risks are not double counted in the different parts of the risk management framework.

An integration can be split in several phases to reduce burden for financial institutions.

Question 20. 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.

The challenge with social and governance risks is that they cut across other risks, such as environmental risks. However, contrary to environmental risks, there are no scenarios associated with a possible material change in the future profile of these risks. Despite that, we believe that EBA should define a central data-set and some scenarios also for social and governance risk.

Question 22. Please provide your views on the incorporation of ESG factors and ESG risks considerations in the business model analysis of credit institutions

The integration of the ESG risks and ESG factors must be based not only on the proportionality principle but also take into account the level of uncertainty (e.g. challenges of long-term forecasting of the business model), especially for smaller financial institutions.

Question 24. Please provide your views on the incorporation of ESG risks considerations into the assessment of the credit institution's internal governance and wide controls.

The requirements for the incorporation of the ESG risk in credit institutions' internal governance framework should follow the same approach as for other prudential risks.

Following the rules of the proportionality, smaller credit institutions should have more time to update their current internal governance frameworks to ensure the explicit inclusion of the ESG risk.

Question 25. Please provide your views on the incorporation of ESG risks considerations in the assessment of risks to capital, liquidity and funding

It should be ensured that ESG risks are not double counted, e.g. in credit models or in the ICAAP/ILAAP.

Furthermore, before implementing binding requirements (via the CRD and IFD), the EBA could perform a Quantitative Impact Study to confirm that the risk is material and assess any proposed methodology. This benchmark would also help disseminate the relevant indicators and methodologies defined by the EBA across institutions.

Question 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.

The EBA could consider embedding more explicit proportionality into the implementation timeline as it did for EBA/GL/2018/02. Like any other risks, institutions should assess if a risk is material and any material risk should be managed.

In addition, a challenge for smaller firms is the need to comply with various regulations, guidelines and other obligations when these are not aligned and cross-referenced. For example, some credit institutions will be subject to SFDR 2019/2088. Such firms should align their risk appetite to their disclosures under SFDR.

Question 27. 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?

If own activities are excluded then some risks that could be viewed as ESG risks are not captured. In particular, compliance and/or conduct risk will be material for some institutions and investment firms and are not incorporated (e.g. the risk that an institution miss-sells ESG labelled products to its customers).

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