Consultation on draft Guidelines on the management of ESG risks

Response to Questions

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Prepared for:

European Banking Authority

Prepared by:

Alvarez & Marsal

ALVAREZ & MARSAL

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alvarezandmarsal.com

1. Question 1: Do you have comments on the EBA's understanding of the plans required by Article 76(2) of the CRD, including the definition provided in paragraph 17 and the articulation of these plans with other EU requirements in particular under CSRD and the draft CSDDD?

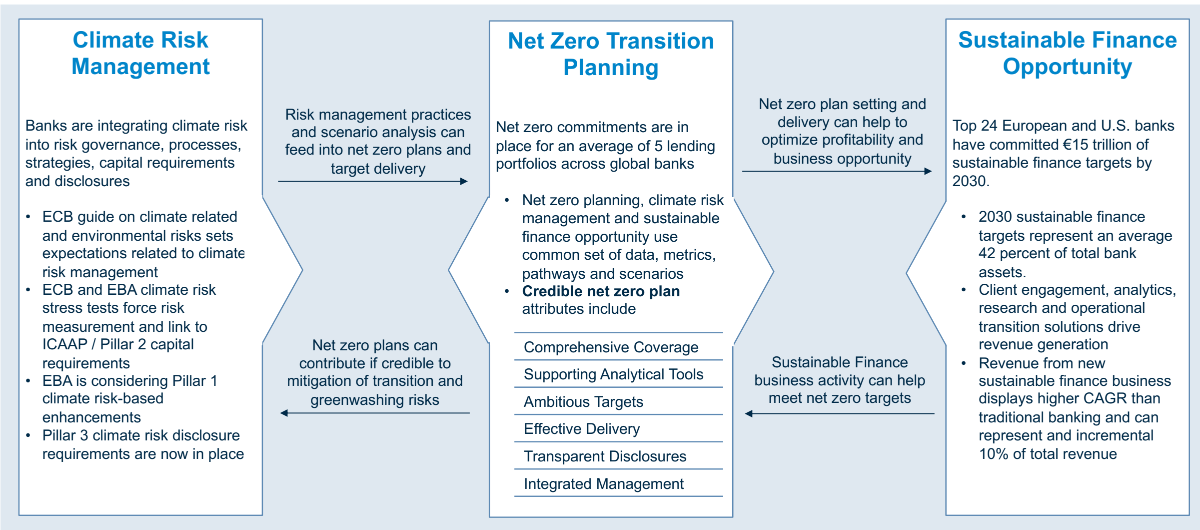
1.1. The EBA draws a distinction between "CRD-based" or "Prudential" Transition Plans and "non-Prudential" Transition Plans. There is only one transition plan, a strategic plan designed by a Bank to reduce operational and financed emissions to net zero levels over the long term. This plan entails financial and operational risks as well as business opportunities in the process of assisting clients in their transition plans. Separating transition plans into two views is not useful or productive. It will be like separating the strategic plan and the risk appetite of a Bank into two differentiated plans separately regulated. There is only one transition plan that should include an integrated view of the following components: 1. Operational plan to reduce scope 1 and 2 emissions; 2. Net zero plan for financed emissions across loan portfolios of the banking book; 3. Financial and execution risks (including scenario analysis and stress testing); 4. Sustainable finance lending, income and profitability targets related to ESG as a business opportunity.

1.2. Banks that deliver credible net zero transition plans are in a better position to optimize climate risk reward trade-offs. We believe transition plans should include a comprehensive and integrated view of the following three interrelated components:

- **Net Zero Transition Planning** – Global banks have defined net zero plans for an average of five high CO2 emission intensity loan portfolios. These plans provide targets over long time horizons including 2030 reduction goals.
- **Climate Risk Management -** Banks are integrating climate risk into risk governance, processes, strategies, capital requirements and disclosures. ESG KRIs and risk appetite limits should be an integral part of the transition plan.
- **Sustainable Finance Opportunity -** Top 24 European and U.S. banks have committed €15 trillion of sustainable finance targets by 2030. Business volume, income and profitability targets should incorporate the reward / business side of the transiton plan.

1.3. Below we show linkages between the three components of a transition plan (see figure 1)

Figure 1 - Integrated Elements of a Credible Transition Plan



2. Question 2: Do you have comments on the proportionality approach taken by the EBA for these guidelines?

2.1. No comment

3. Question 3: Do you have comments on the approach taken by the EBA regarding the consideration of, respectively, climate, environmental, and social and governance risks? Based on your experience, do you see a need for further guidance on how to handle interactions between various types of risks (e.g. climate versus biodiversity, or E versus S and/or G) from a risk management perspective? If yes, please elaborate and provide suggestions.

3.1. We recognise that climate risk is a key component and currently the most debated and better understood one; but we believe that a comprehensive approach to cover the full ESG spectrum is recommended (all the relevant risks across E, S and G should be included, in particular, we believe, E and S).

3.2. Just as an example, based on SASB materiality mapping, Telecommunication Services companies are exposed to the following ESG themes (and therefore risks):

- Environment: Energy management; Materials sourcing
- Social Capital: Customer privacy; Data security
- Governance: Competitive behaviour; Systemic risk management

3.3. Properly understand, assess and manage "S" risks embedded in banks activities and deals – in the example above, for instance, borrowers' exposures to data protection/cyber, etc. – for certain banks may be as if not more important than "E" physical and transition risks.

3.4. There has been a lot of progress on environmental risk standards but little emphasis on social risks and related metrics. Social ESG factors mean different things to different organisations in different sectors; we believe that social risk taxonomies should be developed and deserve similar standardisation as for climate related taxonomy.

3.5. SDGs provide a useful inspiration for a standardisation of social factors; for example, social could be defined starting along 4 key dimensions

- **Human Capital** – related to the people who contribute to the products and services a company offers, including employees, suppliers, etc. It is about diversity, equity & inclusion, work conditions / health and safety, employees development, etc.
- **Product Liability** - related to the impact on society of products and services offered, quality of life, safety, and equitable outcomes. It is about privacy and data security, product and safety quality, etc.
- **Stakeholder opposition** – related to transparency and ethics in business practices. It is about supply chain transparency and traceability and certification, controversial sourcing – e.g. slavery and human trafficking – local community relationships, etc.
- **Social opportunities** – related to contribution to equitable access to resources, health and growth. It is about access to communication, access to finance, access to healthcare, etc.

3.6. We suggest that a materiality assessment (in terms of material exposures to sectors and subsequently to ESG themes / risks) should be the basis to determine, at individual institution's level, what is relevant. Once identified the material ESG themes a mapping of those against the "traditional" financial and non-financial risks (credit, market, operational, liquidity, reputational, etc.) should be performed to inform prudential response.

3.7. We therefore believe that better clarity on the importance of not just climate but all the E, S and G risk is required to ensure institutions act accordingly and accelerate the development of their responses across all the ESG dimensions. Taxonomies for S and G risks can also be helpful.

4. Question 4: Do you have comments on the materiality assessment to be performed by institutions?

4.1. We agree with the overall proposed scope of the ESG materiality assessment. We also agree with the use of multiple time horizons (short, medium and long term). However, we would expect medium and long term assessments to be highly subjective and qualitative / expert judgment based as quantitive projections in banks and other sectors do not go beyond 3 years, and after such time frame estimates lack of projection accuracy or subject to high margins of error. While the use of medium and long term horizons, supervisory expectations on those assessments should be explicitely more high level and expert judgement based.

5. Question 5: Do you agree with the specification of a minimum set of exposures to be considered as materially exposed to environmental transition risk as per paragraphs 16 and 17, and with the reference to the EU taxonomy as a proxy for supporting justification of non materiality? Do you think the guidelines should provide similar requirements for the materiality assessment of physical risks, social risks and governance risks? If yes, please elaborate and provide suggestions.

5.1. In line with comments to question 3, and in line with paragraph 12 of the consultation paper *("...ESG risks materiality assessments should provide institutions with a view on the financial materiality of ESG risks for their business model and risk profile...*") we partially disagree on *"...Institutions should at least consider their exposures towards sectors that highly contribute to climate change as specified in ... as materially subject to environmental transition risks...*".

5.2. We recognise that the sectors listed in Annex I, section A to H and section L, of Regulation (EC) No 1893/2006 are the most GHG emissions intense ones, but there are sectors not included in such list which, from an Environmental perspective, are very important to monitor and require dedicated plans. Forcing Institutions to focus <u>at least</u> on the suggested sectors may have the unintended consequences of not focusing on sectors which, despite being material for the specific institution, are not on such list.

5.3. Example: an institution with high exposure to the healthcare sector (Section Q of the mentioned Regulation), and with very small exposure to some other sectors on the contrary included in the list, may feel entitled to ignore the environmental harm and risks that the healthcare sector faces (waste management, disposal of hazardous materials, recycling, use of plastic, etc.).

5.4. We believe that focus should be led by the materiality assessment from a bank perspective (i.e. where the majority of capital is deployed / the majority of business is focused) rather than from a theoretical severity of the individual risk category.

5.5. This also mean that we therefore support the idea that the guidelines should provide adequate requirements for the materiality assessments of all the other ESG risks as they may, in certain situations, be more relevant (see response to question 3).

6. Question 6: Do you have comments on the data processes that institutions should have in place with regard to ESG risks?

6.1. We agree with the overall expectation on ESG data processes and believe the data requirement list provided is comprehensive

6.2. We would encourange banks to use and disclose data quality scores for ESG data to indicate the level of reliability and accuracy of the information used. For instance, some banks do provide data quality scores along their net zero portfolio targets and current financed emissions based on the percentage of proxies used for client emission data. This approach would allow banks to assess the degree of reliability of the data used when making risk management decisions.

6.3. We would also encourage the use of peer benchmarking for ESG data. The amount of ESG data publicly available is extensive and can provide banks with insights related to their competitive ESG positioning as well as the amount of relative progress in meeting transition goals vs. peers.

7. Question 7: Do you have comments on the measurement and assessment principles?

7.1. In line with our comment to question 4, we would expect medium and long term measurement when involving quantitive projections to lack of projection accuracy and be subject to high margins of error. As a result, it would be useful that regulatory expectations around measurement are framed recognizing those limitations and acknowledging that banks will have to take simplistic projection assumptions when going beyond three years.

8. Question 8: Do you have comments on the exposure-based methodology?

8.1. No comments.

9. Question 9: Do you have comments on the portfolio-based methodologies, including the reference to the IEA net zero scenario? Should the guidelines provide further details on the specific scenarios and/or climate portfolio alignment methodologies that institutions should use? If yes, please elaborate and provide suggestions.

9.1. We believe that alignments to sectoral portfolios, should be mandatory only for sectors to which the institution has material exposure; this may mean that some institutions will have to align to sectoral portfolios for sectors which are not listed in paragraph 36 and/or not covered by IEA (e.g., agriculture)

9.2. Science based scenarios, should be used for the other sectors; for example, the SBTi's FLAG for the forest, land and agriculture sector.

10. Question 10: Do you have comments on the ESG risks management principles?

10.1. No comments.

11. Question 11: Do you have comments on section 5.2 – consideration of ESG risks in strategies and business models?

11.1. In line with our comments to question 4 and 7, we would expect long term scenario analysis and stress testing when involving quantitive projections to lack of projection accuracy and be subject to high margins of error. As a result, it would be useful that regulatory expectations around measurement are framed recognizing those limitations and acknowledging that banks will have to take simplistic projection assumptions when going beyond three years.

12. Question 12: Do you have comments on section 5.3 – consideration of ESG risks in risk appetite?

12.1. No comments.

13. Question 13: Do you have comments on section 5.4 – consideration of ESG risks in internal culture, capabilities and controls?

13.1. No comments.

14. Question 14: Do you have comments on section 5.5 – consideration of ESG risks in ICAAP and ILAAP?

14.1. We agree with integration of ESG risks and transition plans in ICAAP and ILAAP. However it seems that such integration will only require capital add-ons but not capital relief. In the particular case of environmental risks, transition to a net zero economy should be capital neutral. It is true that there will be winners (banks that orderly transition to net zero) and losers (banks that delay transition relative to peers). We believe credible transition plans should drive Pillar 2 capital relief while lagging plans should attract capital add-ons.

14.2. Our proposal to determine Pilar 2 capital relief / add-on for bank transition plans includes 3 steps

- **Step 1 Portfolio Alignment** – Assess Banks' Exposure to Climate Change-Impacted Sectors and Determine Alignment of Loan Portfolio
- **Step 2 Loss Estimation** – Determine quantitative capital add-on or relief by bank based on progress of transition plans for financed emissions
- **Step 3 Qualitative Adjustments** – Adjust capital add-on or relief based on credibility qualitative attributes of bank transition plans

14.3. Below we provide detail procedures for the three steps to stimulate debate and facilitate understanding of our proposal

Figure 2 - Step 1 Portfolio Alignment

OBJECTIVES		
• Assess Banks' Exposure to Climate Change-Impacted Sectors and Determine Alignment of Loan Portfolio		
STEPS		**METHODOLOGY DECISIONS**
1	Define loan portfolios subject to transition risk	• Loan portfolios: Corporate vs. Residential Real Estate or Both • Within Corporate select portfolios within Scope (Pillar 3 climate change impacted sectors by NACE or bank net zero portfolio plans)
2	Measure emission intensity	• Scope 1, 2 or 3 emission data • Absolute emissions vs. relative emission • Relative emission (emission intensity using production metrics vs. client revenue vs. bank exposure)
3	Evaluate portfolio alignment (green / stranded value)	• Define alignment of current intensity or current plus targets • Calculated alignment of current bank level vs. science-based scenarios or vs. bank average (across Europe) or vs. bank average by country and portfolio

Figure 3 - Step 2 Loss Estimation

OBJECTIVES		
• Determine quantitative capital add-on or relief by bank based on progress of transition plans for financed emissions		
STEPS		**METHODOLOGY DECISIONS**
1	Develop climate stress test approach to assess transition risk	• Select time horizon (short term vs. medium term vs. long term) • Scenario design (NGFS scenarios similar to ECB Climate ST 22) • Rely on internal ICAAP vs supervisory stress tests
2	Estimate unexpected losses or gains by portfolio	• Estimate stress loss factors for stranded and green value (aggregate level, by sector and EPC label, by country) • Define maximum levels of capital add-on or relief
3	Calculate overall quantitative capital relief or add-on by bank	• Define calculation process based on exposure, green / stranded value and capital relief / add-on to determine overall quantitative capital adjustment

Figure 4 - Step 3 Qualitative Adjustments

OBJECTIVES		
• Adjust capital add-on or relief based on qualitative attributes that define credibility of bank transition plans		
STEPS		**METHODOLOGY DECISIONS**
1	Determine list of attributes for credible transition plans	• A&M has developed an approach to evaluate transition plans based on six qualitative attributes that define credible transition plans: 1. Comprehensive Coverage; 2. Supporting Analytical Tools; 3. Ambitious Targets; 4. Effective Delivery; 5. Transparent Disclosures and 6. Integrated Management) • Define how qualitative assessment is conducted
2	Determine qualitative adjustment method and level	• Determine level of granularity at which qualitative adjustment to be applied (portfolio vs. sector vs. overall) • Define size of qualitative adjustment
3	Update capital adjustment over time	• Determine frequency of update and supervisory process

14.4. We are happy to provide to the EBA more detailed examples and illustrations of our proposed approach if there is an interest.

15. Question 15: Do you have comments on section 5.6 – consideration of ESG risks in credit risk policies and procedures?

15.1. No comments.

16. Question 16: Do you have comments on section 5.7 – consideration of ESG risks in policies and procedures for market, liquidity and funding, operational, reputational and concentration risks?

16.1. No comments.

17. Question 17: Do you have comments on section 5.8 – monitoring of ESG risks?

17.1. Focus seems only to be on climate; considerations on other "E" risks and/or "S" and "G" should be included; this should be based on the materiality assessment as per above comments. For example, in the "S" domain, Institutions with material business participation in sectors which are highly exposed to "data security" risks should properly continuously monitor those. For instance, A&M developed a social score for Spanish banks with 23 metrics covering gender equality, work environment, social lending and community support. We will be happy to share the study if there is interest by the EBA.

18. Question 18: Do you have comments on the key principles set by the guidelines for plans in accordance with Article 76(2) of the CRD?

18.1. Please refer to answer of question 1 for our views on the elements of an effective transition plan

18.2. EBA guidelines refer a minimum 10-year planning horizon for transition plans and expect full integration with other business planning processes such as ICAAP, strategic / business planning, fuding plans and risk appetite. Many of these business processes rely on short term horizon (typically 3 years and no more than 5-years). As a result, the proposed integration should be done according to the currently available business planning horizons without attempting to extend the horizon of those business planning exercises as it will be counterproductive, innacurate and ineficient.

19. Question 19: Do you have comments on section 6.2 – governance of plans required by the CRD?

19.1. In relation to paragraph 86, sub a): *"…the first line of defense should be responsible for establishing a dialogue with counterparties about their own transition plans and assess consistency with the institution's transition planning. To this end, institutions should ensure that an engagement strategy is clearly defined and that relevant staff possesses sufficient expertise and capabilities to assess the soundness and credibility of their counterparties' transition plans…"*:

- We suggest that the first line of defense should establish a dialogue with counterparties not only about their own climate transitions plan **BUT ALSO** about their control systems and mitigating actions with regards to any other material ESG risks, as identified through the materiality assessment exercise.

- In the example of a Telecommunication Services counterparty, the Bank's first line of defense should engage with the counterparty to understand their ability to detect, manage and mitigate any data security risk, in order to inform business decisions.

20. Question 20: Do you have comments on the metrics and targets to be used by institutions as part of the plans required by the CRD? Do you have suggestions for other alternative or additional metrics?

20.1. In addition to what suggested, we believe institutions should perform a "conversion" exercise of the E, S and G risk they face into the more traditional risk categories (credit, market, operational, liquidity, reputational, etc.) and regularly perform a qualitative / quantitative assessment of the impacts on such "traditional risks". This would also allow an easier comparison of institutions in terms of ESG risk exposures.

21. Question 21: Do you have comments on the climate and environmental scenarios and pathways that institutions should define and select as part of the plans required by the CRD?

21.1. No comments.

22. Question 22: Do you have comments on section 6.5 – transition planning?

22.1. Please refer to answer of question 1 for our views on the elements of an effective transition plan

23. Question 23: Do you think the guidelines have the right level of granularity for the plans required by the CRD? In particular, do you think the guidelines should provide more detailed requirements?

23.1. It is our view that regulatory focus should shift materially to transition planning. Credible transition plans optimize climate risk rewards and can be used as a prudential tool to promote net zero transition of the economy. The EBA guidelines do not provide direction on qualitative requirements for credible or effective transition plans.

23.2. We have defined an approach to evaluate credibility of transition plans based on six attributes: 1. Comprehensive Coverage; 2. Supporting Analytical Tools; 3. Ambitious Targets; 4. Effective Delivery; 5. Transparent Disclosures and 6. Integrated Management.

23.3. Below we provide more detailed attributes of credible transition planning

Figure 5 – Attributes of Credible Transition Plans and Sample Leading Industry Practices

Attributes		Leading Industry Practices	
1 Comprehensive Coverage	• Net zero targets for all portfolios • High coverage of financed emissions • High coverage of total assets	NatWest Group	The bank has analysed more than 50 percent of the balance sheet and set up targets for 15 porfolios vs. industry average of 5
		ING	• ING has developed targets for 9 portfolios excluding coal phased out
2 Supporting Analytical Tools	• Detailed analytics, SBTi assumptions, multi-year pathways and scenario analysis • Use of proprietary tools for net zero setting • Data quality scorecards and engagement	ING	• Terra net zero lending portfolio steering approach pioneered in 2020
		BARCLAYS	• Uses BlueTrack Proprietary Portfolio Alignment tool
3 Ambitious Targets	• Net zero targets set at more aggressive levels than peer average • Targets aligned / below to scientific targets	NatWest Group	Natwest is consistently 1st quartile in CO2 emission net zero target levels
4 Effective Delivery	• Continuous delivery of targets over time • Consistent delivery across portfolios	ING	• The Bank is on track with five of the nine Terra sectors
		BARCLAYS	• Of the prior 4 portfolios disclosed, all are on track
5 Transparent Disclosures	• Comprehensive and detailed disclosures (exposure, emissions and metrics) • Progress reporting scorecard across portfolios	ING	• Detailed targets for nine sectors, climate alignment dashboards, sector outlook, steering actions and client advice opportunities
		NatWest Group	Portfolio progress scorecard and detailed climate risk disclosures
6 Integrated Management	• Integration with client transition strategies • Integrated with climate risk scenarios • Linked to sustainable finance targets and incentives	JPMorgan Chase & Co.	Carbon Compass tool / results are shared with clients for transition advice
		standard chartered	• Bank has developed sustainable finance targets and progress reporting

24. Question 24: Do you think the guidelines should provide a common format for the plans required by the CRD? What structure and tool, e.g. template, outline, or other, should be considered for such common format? What key aspects should be considered to ensure interoperability with other (e.g. CSRD) requirements?

24.1. In question 1 we have provided our view on the reason why one single view of the transition plan is recommended, while highlighting its three key components. Within such construct, to enable a holistic view of ESG risks jointly with the traditional risk metrics and standards, we believe that a standardised "conversion table", as described in our response to question 20, from ESG risks (across all the elements, of E, S and G) to "traditional risks (credit, market, etc.) could be beneficial to set a common understanding and approach when assessing and monitoring risk exposures.

25. Question 25: Where applicable and if not covered in your previous answers, please describe the main challenges you identify for the implementation of

these guidelines, and what changes or clarifications would help you to implement them.

25.1. With many of these topics (outside of climate) being at their early stage of development; we see a potential risk that individual institutions will follow fairly different routes and approaches; this will make supervision more difficult and will end up in future changes. To avoid this, the more prescriptive, in terms of definitions, the guidelines are, the better (e.g. the above proposal of the "conversion table").

25.2. It is important to ensure that transition to a net zero economy should be capital neutral. Regulators have the opportunity to deliver capital relief to those banks delivering on credible transition plans. A capital add-on only approach for ESG risks will be in our view a missed opportunity.

25.3. While ESG risks have a long term horizon, it is important to recognize limitations of current bank business planning processes (that are focused in the short) and adjust regulatory measurement expectations to such existing limitations.

26. Question 26: Do you have other comments on the draft guidelines?

26.1. We believe the a more clear approach about including or not risks other than Climate would be beneficial. The guidelines tend to suggest that they should be interpreted in line with the wider E S and G spectrum but at the same time the level of details and clarity for climate is disproportionate compared to the other ESG risks and components.

CONTACTS

Fernando de la Mora
Managing Director at Alvarez & Marsal
Financial Services Global Leader

fdelamora@alvarezandmarsal.com

Roberto Stucchi
Managing Director at Alvarez & Marsal
Financial Services and ESG FS Leader
rstucchi@alvarezandmarsal.com