AFME response to EBA consultation on Draft Guidelines on the management of ESG risks

18 April 2024

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the EBA consultation on Draft Guidelines on the management of ESG risks. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is registered on the EU Transparency Register, registration number 65110063986-76.

We summarise below our high-level response to the consultation, which is followed by answers to the individual questions raised.

Executive Summary

We welcome the EBA's acknowledgement that "management of ESG risks is still at early stages and a "work in progress" (p.4) and would flag that institutions have made significant efforts to enhance their process to identify and manage ESG risks, despite the continued challenges regarding data availability and the continued evolution of work to measure and address these risks. It is important that the Guidelines acknowledge this and take a proportionate and phased approach, and that the Guidelines form the platform for a constructive dialogue between banks and their supervisors regarding the management of ESG risks - focusing on the important need to understand, measure and manage risks, and avoid creating a "tick box" list of detailed prescriptive requirements.

We welcome the EBA's appreciation of the need to avoid prescribing how institutions should manage ESG risks and focus on the importance of ensuring that banks integrate ESG risks (as a driver of financial risks), across their risk management practices and have plans for the management of material ESG risks over an appropriate time frame. Proportionality is particularly important when considering requirements related to environmental risks beyond climate change and social risks where data availability is at an earlier stage of development. While this should improve over time for companies subject to CSRD (as companies report under the ESRS), this will still not cover many clients, for example non-listed SMEs, individuals and many companies outside the EU.

We would flag that while progress has been made by institutions on the integration of climate risks into their wider risk management frameworks, management of other environmental risks (such as biodiversity and nature-related risks) and social/ governance risks is less advanced amongst both institutions and authorities and presents various analytical and operational challenges. We also believe that a proportionate approach to enforcement of the Guidelines is appropriate, ideally providing for a minimum 2-year implementation period (given the complexity and cross-functional nature of the challenges involved). We also believe that the EBA should seek to encourage a constructive dialogue between institutions and their supervisors regarding the management of ESG risks to facilitate progress and continued advancement as data, modelling and environmental policy continue to evolve. For example, it may be appropriate to adopt a phased approach

across E/S/G risks, to reflect the fact that institutions will only be able to develop their assessment as the underlying quality and consistency of data sources and risk methodologies improves. Given that the intention is for these Guidelines to be regularly updated to reflect developments in the market, it may be most appropriate to focus them explicitly on climate risks initially, and then incorporate other ESG risk drivers as the authorities and industry develop their understanding of these factors, along with improvements to data availability and assessment methodologies.

In parallel, we would also emphasise that the proposed Guidelines should not state similar requirements for institutions' materiality assessment across E/S/G risks, as these may not be relevant for all institutions – nor should institutions' exposures to certain sectors be automatically considered as 'material' but should instead be assessed against a wider set of factors. Institutions should also not be required to comply with a mandatory set of methodologies (such as exposure-based) when conducting their materiality assessments.

In relation to data sourcing requirements, we would recommend that the EBA considers restructuring the Guidelines so that institutions are able to engage with a more clearly structured framework of requirements. For example, we think that institutions should be able to rely on publicly disclosed counterparty information (e.g. through CSRD reporting) where available, rather than duplicating these efforts on an individual basis; institutions should have the option of using external, third-party data providers and proxy sources, ahead of being required to source data through direct counterparty engagement; and in the case of the latter, institutions should have greater flexibility on how to source ESG data in relation to their specific circumstances. On data monitoring, we would highlight that the EU Taxonomy Regulation was not designed as a risk management tool and we do not consider that taxonomy alignment ratios should be included as a mandatory risk metric.

We would highlight that the application of these Guidelines (notably regarding the actions institutions could take to improve their counterparties risk profiles or the engagement with clients), is likely to create an uneven playing field across the global banking industry, with a risk that clients divert from EU institutions to the benefit of non-EU institutions that are not subject to such requirements. There is also a risk of creating a two-speed financial system where EU institutions will finance ESG-mature counterparties – which could be detrimental to companies seeking transition finance, whilst non-EU institutions continue financing "brown" activities.

In relation to institutions' development of prudential plans required under Article 76(2) of the CRD, we believe that this area in particular requires further consideration. Given that a number of international frameworks are under active development, and that the EBA's mandate does not require the publication of these guidelines until 18 months following the entry into force of the CRD, we would suggest that the EBA use the intervening time to coordinate with international standards setters and to align to their approaches as they develop. Further, we would strongly encourage the EBA to conduct further consultation in e.g. 12 months' time to reflect developments in this space and ensure that the guidelines do not risk being outdated at the point of publication.

It is essential to ensure that institutions are able to leverage transition planning (e.g. under CSRD/ CSDDD or international frameworks) without duplicating efforts such as those involved with assessing the materiality of sustainability risks. It is also essential to ensure that transition planning requirements are workable for a global group and maximise interoperability with international standards. For these reasons, we believe that the EBA should take a more principles-based approach to prudential transition plans, at least at this stage, facilitating interoperability with international and other EU standards and enabling banks with global operations to adopt a group-wide approach where appropriate.

We note that the EBA assumes a principles-based approach to the oversight of institutions' risk management in the draft Guidelines, but in parallel appears to adopt a very prescriptive approach to the statement of requirements – for example towards institutions' engagement with counterparties (including their assessment of counterparty transition plans), and the statement of minimum requirements around data sources. Also, as data availability is expected to increase with CSRD reporting implementation, some Member States are requesting institutions to limit their bilateral engagement with clients and collect data from existing regulatory reports as much as possible. We believe that the EBA should adopt a consistent approach towards the design of the proposed Guidelines, focusing on institutions' achievement of appropriate prudential risk outcomes rather than over-specifying the means and/ or method by which institutions should seek to identify, measure, monitor and manage ESG risks.

We would also emphasize that the EBA's proposals should be consistently structured around a risk-based approach in line with prudential objectives. It is essential that the Guidelines are clearly focused throughout on the management of financial risks to the institution (through ESG risk drivers), rather than wider political objectives. Where the EBA does believe that it is relevant to cite external political objectives and targets, it should clearly explain how institutions should consider alignment/ misalignment in relation to their own planning and the implications for any remediation plans. The blurring of the prudential boundary around these plans is also evident through the references to 'objectives' and 'targets' in the draft Guidelines which appear to envisage the decarbonisation or reduction of institutions' impact on ESG factors (by implication through supervisory enforcement).

The EBA state that their intention is for the application date to be aligned with the application date of the amended Directive 2013/36/EU. However, the proposed amendments to CRD only require that the EBA publish these Guidelines within 18 months from date of entry into force of this amending Directive (i.e. the application date), and do not set specific timelines for the application date of the Guidelines. We would question why the EBA is seeking to publish significantly in advance of this date, and apply the Guidelines from the date they are required to publish, effectively front-running the timeline proposed in the Directive. Following the timeline proposed in the Directive would allow additional time for related international initiatives to further develop and to conduct further engagement with industry. It would also allow the EBA to set a practical implementation period for firms which, given the significant degree of change that institutions are subject to (in particular ESG-related requirements), would help support good outcomes across industry.

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?

We welcome that the EBA is seeking to ensure consistency between plans under CRD and broader transition plans under CSRD and CSDDD. It is essential to ensure that institutions are able to leverage wider transition planning (e.g. under CSRD/ CSDDD or international frameworks) without duplicating efforts such as those involved with assessing the materiality of sustainability risks.

We believe that it is also essential to clarify that prudential transition plans are focused on the management of ESG risks and explain the relationship with climate transition plans under CSRD/ISSB and CSDDD, which set out the institution's business strategy and targets for aligning its business with climate change objectives. It is essential to ensure a coherent regulatory framework which minimises overlapping and conflicting requirements. It is essential that prudential transition plans and the role of prudential supervisors are clearly focused on the prudential management of ESG risks and it would be helpful to expressly confirm this in the Guidelines.

Prudential regulators should avoid assessing the credibility of a financial institution's transition plan because transition planning is fundamentally about business strategy. Moreover, given the range of methodological and framework variance on credibility determinations, as recognised by NGFS[1], prudential supervisors are not likely to have the appropriate resources or skills to make credibility assessments, which may also not fall within their microprudential mandates.

We therefore strongly support the EBA's view that plans under CRD are focused on prudential risks with a view to ensuring their institutions' soundness and resilience to the risks faced, forming a risk management tool for institutions to understand, assess and manage ESG risks and that the Guidelines do not require CRD-based plans to set out an objective of aligning with a specific transition trajectory. We strongly agree with the EBA that "the goal of prudential plans is not to force institutions to exit or divest from carbon intensive sectors". This principle should be confirmed in the Guidelines and also underpin any supervisory actions which relate to prudential transition plans. We also strongly support the EBA's emphasis that it is important to provide sufficient flexibility for institutions to tailor their plans to their specific businesses and internal arrangements.

Given that institutions currently face multiple requirements in relation to transition planning across a variety of EU legislative frameworks, it is vital that there is a coherent, clear framework for institutions to work towards. For example, to the extent that EFRAG sectoral standards for the financial sector include additional provisions on transition plans under CSRD, it is essential that the EBA coordinates with EFRAG to ensure consistency.

Beyond ensuring coherence with other EU regulation and standards, it is also essential to take account of international standards and ongoing work at the international level to avoid fragmentation of requirements. For example, we understand that the Financial Stability Board is currently conducting work to assess the relevance of transition plans for financial stability and the G20 Sustainable Finance Working Group is also working on high level principles. Many banks are also applying not only CSRD, but also international frameworks such as the ISSB, Net Zero Banking Alliance (NZBA) and Transition Plan Taskforce. This is particularly important with respect to transition planning requirements as the strategy and targets are generally developed at group, rather than entity, level.

It is also essential to ensure that transition planning requirements are workable for a global group and maximise interoperability with international standards. Banks should be able to leverage work from their global group-level transition plan for the purposes of their prudential plan under CRD. We strongly encourage the EBA to coordinate with international partners to avoid fragmented approaches between jurisdictions and ensure a well understood role for supervisors in relation to transition plans. Many companies and financial institutions have significant international businesses and if there is insufficient consistency and coordination of approaches, there is a risk that companies are subject to multiple, potentially conflicting or overlapping requirements in different jurisdictions with the same objective, particularly if requirements are introduced at entity rather than group level. This would risk undermining the objectives of a clear, comparable framework. We therefore strongly encourage international coordination to agree a common approach.

Given that these international frameworks are in active development, and that the EBA's mandate does not require the publication of these Guidelines until 18 months following the entry into force of the CRD, we would suggest that the EBA use the intervening time to coordinate with international standards setters and to align

[1] See Stocktake on Financial Institutions' Transition Plans and their Relevance to Micro-prudential Authorities, NGFS, May 2023, at page 16.

to their approaches as they develop. Further, we would strongly encourage the EBA to conduct further consultation in e.g. 12 months' time to reflect developments in this space and ensure that the Guidelines do not risk being outdated at the point of publication.

For these reasons, we believe that the EBA should take a more principles-based approach to prudential transition plans, at least at this stage, facilitating interoperability with international and other EU standards and enabling banks with global operations to adopt a group-wide approach where appropriate.

Regarding the proposals for long-term time horizons to be set at a minimum of 10-years, we would note that the only references to a 10-year time horizon in the CRD are:

- Recital 32 of the CRD which refers to the impact of ESG risks over the short, medium and long-term time horizons, and goes on to state that the specificity of climate related and other environmental risks requires in particular "to manage those risks with a long-term horizon of at least 10 years"; and
- Article 87a(2) which refers to the need for strategies, policies, processes and systems to "consider the short, medium and, a long-term horizon of, at least 10 years".

Further, in the EBA's report on the management and supervision of ESG risks, the explanations of the need to extend the long-term time horizon in paragraphs 170 and 337 also focus on the consideration of climate and environmental factors.

Given the uncertainty around social and governance factors, along with the lack of clear long-term goals for any jurisdiction, we believe that it should be made clear that the definition of "long-term" as at least 10 years is specific to the climate and environmental elements of ESG risk management, and for the purposes of prudential transition plans. Should further insight as to the appropriate timeframes for these factors emerge as authorities' and institutions' progress further on Social and Governance factors, this could be incorporated into the Guidelines as part of the regular updates to reflect progress made proposed in Article 87a(5) of the CRD.

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

We think that the proportionality principle should be clearly linked to the risk profile of the institution, as reflected in the results of the institution's materiality assessment. . This would ensure that institutions are able to prioritise material risks across the consideration of E/S/G risks, the range of financial risk stripes and the degree of appropriate counterparty engagement. We therefore believe that the Guidelines should emphasize a sequential approach, prioritizing environmental risks to social and governance risks, to reflect the fact that institutions will only be able to develop their assessment as the quality and consistency of data sources and risk methodologies improve in relation to social and governance risks. Furthermore, we note that social and governance risks are not comparable to environmental risks as a financial risk channel.

We think that the EBA should provide more clarity regarding how institutions' approach towards the proportionality. For example, it is not clear if institutions are only expected to consider adjustments in those portfolios where material risks are identified. In addition, the EBA should also provide a more transparent cost-benefit analysis of the proposed requirements in the draft Guidelines, given that the incorporation of ESG-related risks into the prudential risk framework will imply a significant workload for institutions – it is therefore important that the proposed requirements provide actual value-added both from an ESG risk management and supervisory perspective.

Due to the lack of available market/ consistent data, we would strongly advise to implement institutions' client assessment regarding ESG progress to follow the ESG reporting path as outlined in the CSRD: for larger companies in 2025 over the year 2024, followed by smaller companies in 2026 over the year 2025. It is important to develop a common taxonomy to assess client's ESG status and progress against for this category of smaller (non-MSCI serviced) clients.

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.

As the EBA has recognised, institutions are more advanced with respect to the measurement and assessment of climate-related risks. We believe that given the relative lack of data and benchmarks in relation to the consideration of social and governance risks, or even biodiversity and nature-related risks (compared to climate/ environmental risks), the EBA proposals should emphasise more flexibility here. We would also recommend that the EBA consider developing a common risk taxonomy across these risk areas.

In particular, we do not think it is appropriate to propose minimum requirements in relation to social and governance risks, as per paragraph 24. We believe that more flexibility should be provided to institutions in this respect. We also think that there should be a greater distinction between climate and environmental risks, starting with climate risks and then phasing in consideration of environmental, social and governance risks. We also do not think the draft Guidelines are sufficiently clear on how institutions might develop social or governance transitions plans, given the limitation in data, methodologies and benchmarks across these areas. We would underline that the development of tools and practices to address social and governance risks should be subject and proportional to institutions' materiality assessment across relevant financial risk types.

The evidence base on which to establish transition channels for environmental, social and governance risks is not yet established. This would be the minimum requirement on which to begin developing approaches to risk management, and requirements for these risks should not be in place until such pathways can be evidentially established. Additionally, there is a data dependency on other sectors' implementation of the CSRD and other reporting standards such as the ISSB. For all risk types, a careful assessment should be conducted of whether 'real economy' reporting requirements have been sufficiently established in advance of expectations for financial institutions.

As stated in our response to Q2, we think that that the Guidelines should emphasize a sequential approach, prioritizing environmental risks to social and governance risks, to reflect the fact that institutions will only be able to develop their assessment as the quality and consistency of data sources and risk methodologies improve in relation to social and governance risks. We would also stress that even if potentially all types of risks may be impacted over time by ESG factors, this is not the case yet. Therefore we believe that the EBA should phase the implementation of the proposed Guidelines with reference to those risk types where the materiality of impacts have been demonstrated (such as credit and operational risks).

We would highlight that the Guidelines proposed by the EBA may create an unlevel playing field with non-European institutions, which will not be subject to such requirements and may continue to finance counterparties which demonstrate weak ESG engagement while EU institutions will be required to finance counterparties that are already mature in their ESG transition profiles. This will also reduce the ability for EU

institutions to provide transition finance. While collecting data to assess counterparties' ESG risk profiles may be appropriate (provided institutions can leverage CSRD data to reduce the burden on their counterparties), differentiating treatment based on these ESG profiles would seem counterproductive, given that these counterparties might divert from EU institutions to the benefit of non-EU institutions which would not be subject to the proposed Guidelines).

We would also highlight that in the case of interdependencies between environmental, social and governance risks, we do not believe that categorical guidance can be provided on how institutions should deal with such interactions – instead we would recommend that any dependencies should be considered in institutions' individual risk assessment.

While we appreciate the principles-based approach of the EBA's proposals in relation to environmental, sustainable and governance risks allow flexibility for institutions to interpret as most relevant to them, and to develop their approaches over time, some degree of baseline as to the expectations that institutions would be assessed against would be helpful.

Additionally, 'environmental and social materiality' is analogous to 'impact-materiality' as defined under CSRD, however the definition is not fully in line with the CSRD definition. CSRD defines impact materiality as impact on the environment and society (assessed in terms of scale, scope and irremediable character) regardless of any potential financial implications. If an adverse impact is likely to have financial consequence for a company e.g. a fine or a remediation obligation for an unpermitted pollution event, then it becomes a financial risk to the company as well as an adverse impact on the environment so the financial risk should be considered as under an ESG risk management framework. "Impact materiality" therefore has an implied meaning in the Guidelines that is inconsistent with CSRD. We recommend that the Guidelines refer to financial materiality only since they are focused on risk management, but it should made clear that this may include financial risks from adverse impacts that a company may have. Impact materiality is relevant when companies are disclosing from a double materiality perspective (e.g. GRI, CSRD reporting) however, there are not always transmission channels that would make impacts into financial risks.

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

We believe that the emphasis here should be ensure appropriate flexibility for institutions in deciding their specific approach to materiality assessments, to ensure that these are suited institutions' actual sectoral footprint and in order that institutions are able to undertake appropriate ESG risk assessments consistent with the double materiality assessment referred to in the ESRS and CSRD. Institutions should be able to perform one single exercise in order to identify the risks included in the IROs described in the ESRS. We also believe that the guidelines should focus on financial materiality given the function of the Guidelines to support institutions' risk management. While the impact of an institution's activities on ESG factors may result in financial risks, for example through reputational risk, it remains important to ensure that the guidelines are clearly focused on management of financial risks to the institution.

The draft Guidelines set the time horizons consistently across ESG risks. While we understand to some extent the reasoning for the long-term time horizon in relation to climate risks, it is unclear that it is consistently applicable across environmental, social and governance risks. Similarly, for institutions with short-term exposures, longer-term risks may be more limited than those which have large volumes of 10 year+ exposures. As such, it would be helpful for the EBA to clearly recognise that a firm's materiality assessment process may identify no material risks in the 10+ year time-horizon, or may conclude that the primary risks requiring active management exist within the short - or medium-term time horizons.

We would also highlight that the materiality assessment for the time horizon proposed (including at least 10 years) is too long to be used for financial resource planning: liquidity assessment (including stress testing & planning) focuses on short to medium term risks, making it difficult to cater for long term events; while a capital assessment focus (including stress testing and planning) beyond 5 years would not be meaningful.

Paragraph 14 refers to "comprehensively capturing potential impacts of ESG risks". Comprehensively capturing all potential impact associated with ESG risks is fundamentally impossible, and in any case would require an amount of effort and cost wholly disproportionate to the risk management benefit of doing so. As such we would suggest that this be amended to read "With a view to capturing the material potential impacts of ESG risks".

Paragraph 14(a) requires the use of both qualitative and quantitative elements and data across all of ESG. As recognised elsewhere in the guidelines, quantitative approaches to social and governance risks may not be possible at this stage. We would propose that this element be amended to read, "The consideration of both qualitative and quantitative elements and data where these are available". Additionally, paragraph 14 should be amended to specifically recognise that there is more of a limitation on their application for social and governance risks.

The reference in paragraph 14(c) to assessing divergence of counterparties from transition objectives is too prescriptive and assumes an unproven correlation between transition recalcitrance and the counterparty risk. Institutions should be given the flexibility to define their own approach to assessing materiality, including making their own judgements as to whether counterparty divergence from transition objectives is a relevant factor given the nature of their exposure to that counterparty.

We welcome that the EBA is seeking to understand how the entities are managing the risks associated with the transition of certain sectoral portfolios, based on a materiality assessment (paragraphs 16 & 17). We believe that these requirements are best implemented by institutions through the formulation of a business plan, which includes the identification of opportunities with existing and potential clients, and a tiered approach to define the institution's risk appetite towards clients across sectors. These business plans should allow the definition of projected decarbonization curves for each sector to monitor progress in the alignment exercise. Additionally, the plans should be updated with the outcomes of Stress tests and scenario analysis, to allow the projection of risk metrics such as Expected Loss or concentration parameters that should be compatible with the institution's risk appetite, as reflected in the institution's risk policies or wider industry frameworks.

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 nonmateriality? 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.

We would highlight that a materiality classification can only be conducted if certain quantitative/ qualitative materiality thresholds are met. Furthermore, a materiality classification of certain sectors does not automatically imply materiality from an individual institution's perspective, given that the latter would vary for example across business model and exposure type.

The specification in the Guidelines is highly prescriptive and includes hundreds of NACE codes. Under the proposal, institutions would have to justify their decision that a specific sector is immaterial, which in practice would require them to assess the materiality of exposures under all NACE codes. This would create a huge data and assessment burden even when it is qualitatively obvious that the NACE sector in question poses no environmental risks to the institution.

This approach is also inconsistent with the list of sectors provided by the International Energy Agency (IEA) for their Net-Zero Emissions (NZE) scenarios, well-recognised and adopted globally, as the activities in sections E, F and G are not included in the IEA NZE.

While the Guidelines do allow institutions to assume immateriality for sectoral exposures that are Taxonomy-aligned, this still poses two problems: first, it would require institutions to assess Taxonomy-alignment even when it is clear that the exposure is immaterial; and second, it conflates 'brown' characteristics with transition risk, which is not justifiable.

Therefore, we do not agree with the specification of a minimum set of exposures to be considered as materially exposed to environmental transition risk. This does not represent a sufficiently granular criteria, as this would nearly covers all sectoral activity, while this requirement also does not take into account the specific client's situation. We therefore believe that the Guidelines should give flexibility for institutions which depending on their business model have already developed a materiality assessment tool with a granular approach to allow differentiation between clients, rather than initially factoring in an entire list of activity sectors.

We do also not agree with the reference to the EU Taxonomy to exclude some sectoral activities, first because alignment with the EU Taxonomy would not directly imply less ESG risk (given that the EU Taxonomy regulation does not classify activity from a risk-based perspective), and further because this would not provide a complete picture (as non-EU exposures would not come under the scope of disclosure and the EU Taxonomy does not cover all sectors of the economy).

We do not believe that the proposed Guidelines should provide similar requirements for the materiality assessment across E/S/G risks, as these may not be relevant for all institutions – again, the emphasis should be on flexibility for each institution. The materiality assessment for social, governance, biodiversity risks should be done in a best effort basis at this stage. We would also highlight that industry proxies for smaller clients may lead to unintended qualifications regarding their footprint. Therefore, we would recommend the application of a size-threshold applicable to institutions' materiality assessments, as well as an agreed risk taxonomy on the qualitative elements of the assessment of the various E/S/G categories. We would also emphasize that a sectoral approach may not be appropriate for all environmental and social risks – for example, other dimensions may need to be considered in order to tackle other environmental and social risks. We do not believe that exposures towards certain sectors should not be automatically considered as 'material'. Instead, other factors should also be taken into account, such as the maturity of the loans; if the exposures belong to a diversified business group or if the corporate has the ability/ willingness ability to shift its business model; or if the sector itself has the possibility to decarbonise.

The potential ambiguity over the 3-5 year time horizon should also be considered by the EBA. Please also see comments in response to question 18 below regarding aligning time horizons with the CSRD.
It would also be helpful if the EBA should clarify whether there is an expectation on institutions to look through to underlying exposures (for example in a CLO or Covered Bond), and how this contributes to rating materiality assessment.

Question 6: Do you have comments on the data processes that institutions should have in place about ESG risks?

Data requirements should be determined using a risk-based approach as some data points are more important to assess risk in certain sectors, and some are likely to be higher data quality than others. For example, collecting scope 3 emissions data both up and down the value chain is unlikely to be a useful tool in risk identification, but certain categories of Scope 3 emissions might be a better indicator (e.g. from food production, or use of sold products). Equally for asset-based data - certain types of long-lived assets may be more exposed to risk than property, for example.

Given that institutions will face the challenge of limited quantitative data, we think that is important to consider the implications for institutions' approach to risk management. This is particularly acute for social and governance risks, where risk-related data (and associated management methodologies) may not be as advanced as for climate/ environmental risk assessments. Furthermore, in relation to the gathering of counterparty data (including for large corporate counterparties), we believe that this should be based upon a materiality assessment of the risk of the counterparty, and therefore would recommend that this point is confirmed in the finalised Guidelines. We also consider that that the requirements in paragraph 21 are over-prescribed and institutions are best placed to decide how to source ESG data in relation to the specific characteristics of their portfolios. In addition, some data listed in paragraph 23 may be difficult to collect for institutions (for example, the collection of energy performance certificates for exposures collateralised with real estate).

We also believe that public administrations should support the development of public databases relating to information on corporate emissions, asset localization and insurance coverage, given the cost implications for gathering this information at an institutional level.

In relation to paragraph 22, it would be helpful for the EBA to clarify that where sufficient data is available under CSRD disclosures, client engagement may not be necessary. Financial institutions should rely as much as possible on ESG-related data publicly disclosed by counterparties under CSRD, and complemented by external data providers when such information is insufficient. Therefore, we do not agree with the draft Guidelines that institutions should engage with their counterparties to collect data. To note that this would increase the burden for counterparties, which may not understand why additional data collection is needed while they have expended significant resources to produce CSRD data (which are submitted for external assurance review). In the case of counterparties that are financial institutions, data collection may prove to be very difficult, as these firms will have to look through to a potentially large number of counterparties to which they can be engaged indirectly via investment in funds. We believe that the collection of additional data directly from engagement with counterparties should complement reported data when both necessary and possible, and should be limited to (large) corporates. For corporates outside the EU, this information should not be requested or should be provided on a best-efforts basis. We would therefore recommend that the data collection process referred to in the Guidelines needs to be clarified.

Regarding paragraph 23(a), we do not support the requirement to provide all the metrics and units as specified by the Guidelines. Financial institutions should be given flexibility and choose the most relevant and appropriate metrics according to each institution's business model or risk management framework. For example, for some sectors the physical intensity per unit of production is more relevant, while for others it might relate to the technology mix or both. Therefore, institutions should have the option of using the same metrics as those used under NZBA portfolio alignments and not be required to define additional metrics (particularly for those institutions that are part of the NZBA). Furthermore, the inclusion of litigation risks

may not be practical in all cases. In In some cases, detailed information on imminent or pending litigation is likely to be restricted, and gaining sufficient information to determine the relevance, impact and likelihood of outcomes from a litigation will prove extremely difficult. We would propose amending this provision to include "where available".

We recommend that the EBA provides more clarity in relation to paragraph 25, where the Guidelines require institutions to remediate for the lack of data (using proxies at first), but then reducing reliance on those over time. Given the relative lack of data around ESG risk drivers compared to other financial risk drivers, we would appreciate more clarity around the timeline on improving data quality and availability. As institutions will use this data to support their materiality assessments, this underlines the need for institutions to be granted appropriate flexibility to determine their specific approach, so that they can take into account that dependence on these proxy sources may change over time, as direct data becomes available. Institutions should also not be held responsible for potential differences between initial data (whether estimated or proxies) and real data when this becomes available.

We would also propose that the EBA allow for the assessment of ESG factors at a portfolio level rather than the counterparty level, in line with the EBA Guidelines on Loan Origination and Monitoring. This would relieve some of the burden on smaller counterparties, while also obtaining a degree of information appropriate for risk management purposes.

Furthermore, with reference to paragraph 25(b) of the draft Guidelines, these requirements could be read to include data acquired from ESG rating providers, including ESG ratings. We do not believe that it is the role of institutions to ensure the quality of this data – instead, we understand that ESMA would be in charge of the supervision of ESG rating providers as per the inter-institutional agreement reached on 5 February 2024.

We believe that the EBA needs to provide more guidance on how institutions should approach the sequencing of data around the implementation of the proposed Guidelines in relation to other EU legislative items, such as CSRD. Institutions will need to develop a realistic, prioritised schedule of data development, in order to meet requirements across multiple legislative frameworks. We note CSRD disclosures will not solve the lack of data in the short term or longer term across the range of institutional portfolios.

Specifically in relation to client and asset-level data, it is not clear if the EBA's intention is for these data points to be tracked KPIs over time, or if counterparties will even have access to this information. It is also not clear if the intention is to translate these data points into transition plans (e.g. should plans have KPIs related to % of revenue related to fossil fuel sectors?). Therefore the EBA should consider further clarification in this area.

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

We note that the mapping of exposures to individual risk drivers would be extremely challenging and would represent questionable benefit in terms of risk management information versus the effort/ cost involved for institutions.

The draft Guidelines refer to the mandatory collection of data from large corporate counterparties in para 23. We believe that the articulation of Key Risk Indicators should only apply to engagement with large corporates, rather than across the range of counterparties, as suggested in para 28. We also think that a clearer distinction between the different client typologies should be made.

We understand that the EBA will be publishing updated stress-testing Guidelines in relation to institutions' assessment of climate risks – we would recommend that the EBA includes specific guidance on how institutions should combine top-down and bottom-up scenarios within their stress-testing methodologies.

From our perspective, the Guidelines should only apply to the Banking Book and not to the Trading Book, given the difference in time horizons and current data and methodological constraints and the fact that currently material risks from ESG factors have been only identified in relation to the Banking Book. Also, given the short-term nature of Trading Book exposures, and existing mechanism in place to reduce financial risks (e.g. daily margining of cleared transactions), ESG risk is generally low. Moreover, the assessment of risks driven by ESG factors would be complex, as Trading Book transactions are numerous (across secondary and private markets), and instruments can be held for very short periods of time. Furthermore, institutions acting as intermediaries will be taking and hedging positions on behalf of clients but not taking risks for a period of time that would expose them to ESG risks. Finally, it is unclear which values it would make sense to consider when assessing ESG risks in relation to Trading Book transactions – mark-to-market, which is often used to determine a transaction's financial risk, would not be relevant when assessing ESG risk factors, as the value of a transaction barely considers the exposure of the underlying to ESG risk factors.

To note that the attribution of share price or CDS spread changes and/or heightened volatility to ESG risk factors would be challenging at best, and historical data series required for backtesting are not currently available.

If the Trading Book is to be covered in the finalised Guidelines, a phasing-in would be necessary to determine the correct methodologies and to capture a scope of data that would be expected to be broader than just for the Banking Book.

In relation to paragraph 27, the Guidelines should make clear that for one portfolio institutions might use one methodology and for other portfolios they can use a different methodology – namely that portfolio-specific methodologies are appropriate and permissible.

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

We do not believe that the proposed exposure-based methodology should be imposed as a mandatory requirement, particularly given that institutions will have already internally developed their materiality assessments. The EBA should therefore provide flexibility to institutions and not impose a single methodology. In addition, the proposed exposure-based methodology should be subject to the materiality assessment in Section 4.1.

As the prudential treatment of ESG risk assumes that institutions adopt a risk-based approach, we do not think that it would be relevant to use the reference to the EU Taxonomy as a proxy for supporting justification of non-materiality (as a derogation to default sectoral exposures materiality assessment, par. 17), given that the EU Taxonomy is not risk-based. We would also highlight that there is no evidence to date of a positive risk differential according to "green" vs. "brown" features of counterparty activities.

We consider that the draft Guidelines are too prescriptive with respect to requiring engagement with clients to obtain data and conduct due diligence processes (paragraphs 32 and 33) at the exposure level. This would be extremely burdensome for institutions and their clients, and it introduces a requirement that goes beyond due diligence requirements under CSDD whereby Financial Institutions downstream value chain is out of scope. Instead, we believe that engagement should be limited to areas where material risks are identified to

ensure a proportionate approach. We also note that it would not be practicable for institutions to engage with smaller companies for this purpose – furthermore, if smaller companies are exempted from providing certain information, institutions should not be required to engage with these companies to secure this information.

Data integrity and alignment between institutions should benefit from limiting the scope of client data to data publicly disclosed by clients. There is a data quality issue and audit issue if the data collected is not publicly disclosed by the client. The same client data should be used by all institutions, and should be possible for auditors to locate (i.e. not based on data received during a client dialogue).

The requirement under paragraph 33 to consider social and governance risks over short-, medium- and long-term time horizons appears to contradict the earlier paragraph 27 which sets out that the exposure-based methodology should be used for the assessment of short-term risks. In relation to paragraph 30, covering internal risk scoring and rating models, we believe that counterparty ratings can be adjusted through expert judgements, by way of overrides. It is too early and premature to modify rating models, as institutions are lacking the evidence and historical, backward-looking statistical data to facilitate this work. The approach proposed in the draft Guidelines may jeopardise the whole equilibrium of rating models.

On paragraph 31(c) regarding the clients' value chain aspect, we suggest that EBA clarifies its position regarding the value chain. We believe that only broad questions should be asked in the clients' onboarding and monitoring processes, i.e. if they have selected suppliers based on ESG criteria or if they include ESG clauses in their contracts. It should not be the responsibility of the institution to analyse the upstream or the downstream value chain of its customers. We recommend that the Guidelines clearly state that the information should be provided by the clients and gathered by the institution to comply with the due diligence principles. In addition, a clear distinction should be made in the Guidelines for financial counterparties where information on their full value chain is not possible to obtain (as is the case under the CSDDD, where financial institutions have a limited scope in terms of the value chain).

On paragraph 31(c), regarding the likelihood of business-critical disruptions due to physical risk, the internal indicators typically developed by institutions consider whether is an exposure to the physical risk, rather than the "likelihood of the occurrence". In any event, we believe that the 'likelihood of the occurrence' is not relevant, given that business disruption is dependent on multiple factors (potentially including environmental factors). Furthermore, in relation to physical climate risks the diverse types of impact would be difficult to reduce to a binary occurrence/non-occurrence assessment. Therefore in order to maintain flexibility of approach, we recommend that the Guidelines refer to "exposure to the critical disruptions" (in place of the current reference to "the likelihood of critical disruptions).

We also note that paragraph 33 would require institutions to implement due diligence processes to verify counterparties' adherence to social and governance factors, although it is not clear how these factors would drive prudential risk aside from certain severe scenarios – therefore we believe that institutions should be allowed to make their own assessment of the relevance of these factors to their risk management.

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.

We note that the net zero GHG objectives/requirements under the Climate Law and Fit-for-55 apply to Member States, not institutions. In the absence of such institution-level net-zero requirements, it is not

therefore clear why institutions should be required to factor the climate-related portfolio alignment into their risk management practice, nor why they should be required to implement climate-related portfolio alignment methodologies. Instead, we believe that institutions are best placed to judge which risk management methods are optimal for their business model and risk appetite, so should be provided full discretion to pursue the most appropriate approach.

We therefore believe that the Guidelines should take a more neutral approach – i.e. they should not define the sectors to which these methodologies apply, nor the scope within each sector. Instead this should depend on institutions' materiality risk assessment. We also note that the Guidelines currently provide an exhaustive sector list that is not always comparable. For example, in relation to the steel sector, the Guidelines assume the application of the methodology around the Sustainable Steel Principles, which is highly data intensive. However, in relation to the chemicals sector, there is not a single agreed methodology – therefore we recommend a more neutral approach, through which institutions are provided with more flexibility to perform this assessment.

It is important to note that institutions will not be able to implement the proposed methodology to measure benchmark scenarios as referenced in paragraph 35(a), given that institutions do not have access to 1990 portfolio data and there are not sectoral transition pathways in place at the EU level. Therefore we believe that the EB should provide more flexibility in this area. We also would like to highlight that for the EBA ST fit-for-55 exercise, institutions were requested to refer to 2022 as the baseline year. The priority for institutions should be to develop a methodology of portfolio alignment in relation to the wider EU target, in order to identify the gap between this target and institutions' own portfolios and manage the risk arising from any gaps.We also think that a key area of focus is the extent to which institutions can monitor the carbon intensity footprint of their portfolios that have a smaller footprint compared to 'high impact industries', given that any gap might only be closed once CSRD results are known and are captured in institutions' internal systems (e.g. after 2026).

We also note that since IEA scenarios are not available for the agricultural sector (which is a large sector in terms of emissions) nor forestry, more sectoral pathways should be considered. These pathways should be aligned with the 1.5C target with no or limited overshoot and in general fulfil the criteria set out in the GFANZ guidance on sectoral pathways[2]. We note that the GFANZ guidance contains detailed methodology and provides public access to data/assumptions; they provide some sector-level granularity; they are aligned with the 1.5C target; and they are widely used/ recognized by financial institutions.

We also note that the sectors specified in paragraph 36 are not aligned with NZBA sectors, which are used today to set targets, monitor metrics, and pilot their transition plans. We are therefore stressing the necessity to take into consideration the NZBA framework including sectors, scenarios, metrics and targets.

The EBA's proposals include the requirement for large institutions to develop methods to identify natural capital dependencies, and approaches to measuring the impact of their portfolios on the achievement of UN sustainable development goals, and associated risks. There is no industry framework for translating misalignment with UN SDGs (goals for governments) with financial risks to counterparties. Furthermore, this duplicates the CSRD which asks financial institutions to report on positive and negative impacts to the wider environment and society, regardless of whether or not they represent a financial risk. In line with our comments in response to Q3, to enable institutions to implement such requirements consistently and to

[2] https://assets.bbhub.io/company/sites/63/2022/06/GFANZ_Guidance-on-Use-of-Sectoral-Pathways-for-Financial-Institutions_June2022.pdf

preserve the level playing field, it is important that the EBA provide a supplementary document setting out their view of best practice in these methods and approaches, to establish a clear benchmark for institutions.

In relation to the future Guidelines on scenario analysis, it would be helpful for the EBA to provide additional detail on the anticipated timelines and scope.

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

We are concerned that there does not appear to be any proportionality around the proposed requirement for institutions to engage counterparties, as specified in paragraph 42(a). We would also emphasize that scope of counterparty engagement should be linked to institutions' materiality assessment. In addition, we note that the reference in paragraph 42(a)(i) to 'most critical counterparties' is not specified.

We also believe this could create important level playing field issues, where EU institutions could become less competitive than non-EU institutions, which do not face such requirements. It may also disincentivise institutions from providing transition finance. To note that in the case of syndicated loans where several institutions are involved, it may be complex to unilaterally change the financial terms and conditions.

In relation to the requirement for institutions to assess counterparties' transition plans, we note that institutions will rely upon such plans being subject to external audit – therefore while institutions may have developed internal procedures to assess such plans, they should not be primarily responsible for assessing the credibility or accuracy of these plans.

We do not think that institutions should be made responsible for determining the credibility of counterparty transition plans, given the excessive burden this would place on institutions, and misplaced responsibility. We also note that counterparties will engage with multiple institutions, which therefore creates the risk of conflicting objectives in the event that each institution's risk assessment leads to different outcomes/ priorities. Institutions would rely on the external auditors' assessment as it would become part of their remit to assess clients' transition plans. We would also flag that under a syndicated facility, the agent would never take the responsibility to make this type of assessment.

The requirement under paragraph 42(a) for institutions to assess large counterparties' processes to address greenwashing risks could create a liability for institutions in relation to their counterparties' greenwashing capabilities. It would also be necessary for the EBA to clearly define greenwashing for these requirements to be implemented consistently. To note that institutions are already implementing processes to avoid and/or mitigate greenwashing risks, while awaiting the publication of the ESAs' final report on greenwashing in order to implement its recommendations. We would also note that firms already have processes in place to assess clients' approaches to managing reputational risks and litigation risks more broadly, which would cover these requirements to the extent it is appropriate for risk management purposes.

The EBA should also provide more clarity around the expectations on institutions to develop metrics on their engagement with counterparties, particularly on what would be representative in terms of engagement (e.g. large v smaller corporates, EU v non-EU counterparties?).

Paragraph 42(d) requires the diversification of lending and investment portfolios on ESG-relevant criteria, which implicitly links with the categorisation of activities under the Taxonomy. This could be interpreted as requiring firms to take on "green" businesses to balance exposures to "brown" businesses. Given that the

Taxonomy is not a risk management tool, this could distort firms' portfolios, and interfere with risk management practices.

We also note that in the case of large corporates, these are likely to be involved with more than one institution. Therefore there is a risk that different institutions may have different assessments and/ or expectations around a counterparty's ESG risk profile, which could create significant complexity for both institutions and counterparties. In this situation, we would recommend that institutions should seek to pursue a directional approach to engagement around a counterparty's risk profile, rather than pursuing specific alignment with the institution's risk management trajectory.

Additionally, the EBA do not appear to consider the acceptance of risk levels as a valid approach to the determination of risks. The ability to bear risks is central to institutions' functioning, and will be necessary to allow for the funding of the transition process. Institutions should be able to accept risks within the bounds of their risk appetite.

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

We do not think that the proposals in this section should be framed in a way that might potentially constrain institutions' approach to business model and strategic planning (e.g. through supervisory oversight). Regarding paragraph 43(b), we do not think that it is appropriate to make any connection at this stage to institutions' P&L. Institutions should be given some flexibility to run their business model and strategy as long as they can demonstrate they have put in place a governance and a sound risk management framework. For example, we believe that an assessment of the potential cost impacts of ESG risks through internal stress-testing exercises would seem more appropriate.

We would also emphasise that institutions' assessment of ESG risks should be incorporated in their normal (credit) risk management processes and form an integral part of their counterparty risk assessment. We would also flag that the EBA should consider clarifying how institutions should assess ESG risks relating to non-credit relevant clients within their portfolios.

In relation to the expectations set out in paragraph 44, the EBA should clarify whether these methodologies are specific to climate and environmental risks, or whether it expects that these will also apply to institutions consideration of social and governance risks. If the latter, the EBA should provide more guidance on their application.

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

While we acknowledge the EBA's proposal that ESG risks should be incorporated into institutions' risk appetite statements (RAS), we do not see a clear differentiation in the Guidelines between the risk appetite framework and the general limit/ threshold framework that an institution can have at a lower management level. We think it is important to make this differentiation, as we think that overwhelming the risk appetite framework with ESG-related risks would impede the correct functioning of this framework. We would also recommend that institutions should be provided with the flexibility to determine the choice of metrics they use to structure their RAS (and avoid the stipulation of a mandatory, potentially excessive set).

The EBA also seem to interpret ESG elements as drivers of traditional risk, so it is unclear how ESG risks can be incorporated explicitly into risk appetite statements without double-counting. Therefore it is not clear why ESG should play a separate role as a risk driver when determining risk appetite compared to traditional risks.

As per our response to Q2 and Q3, we believe that the Guidelines should emphasize a sequential approach, prioritizing environmental risks to social and governance risks. We also note that that in the case of social and governance risks, institutions may rely upon qualitative information when setting their RAS, given the relative lack of quantitative data and metrics in these areas.

The EBA should also consider the potential tension between the time horizons specified in the Guidelines towards the assessment of material ESG risks, and the time horizon that institutions will adopt when setting their individual risk appetite. Given that the majority of material ESG risks will only materialise over a 10+ year horizon, the EBA should clarify that institutions' risk appetite should be set for a shorter-term perspective.

To note that for large institutions, metrics and targets have to be set at a consolidated level. Cascading such metrics at lower levels would not be the most efficient way to ensure that the targets set at the consolidated level would be met. Instead, a combination of origination policies and close monitoring could prove more efficient and would avoid potential adverse effects.

Paragraph 47 states that institutions should use backward-looking and forward-looking indicators tailored to their business model and complexity, However, we would flag that institutions do not currently possess backward-looking indicators or information to fulfil this requirement. As we understand the rationale for this requirement, we would therefore recommend institutions focus on gathering historical data that they can use to anticipate the materialization of future negative climate-related events (although such data should be tracked back to at least 10 years in order to not overestimate ESG risks).

In relation to paragraph 48, we believe that the consideration of ESG risks in institutions' risk appetite should be aligned their management of such risks in relation to their geographical footprint, business diversification, and other factors. We do not think that institutions should be required to change their management processes on account of a requirement to cascade internally. Instead, risk appetite should be monitored in those risks deemed material according to institutions' own models and internal procedures (e.g. at client level, portfolio level).

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

We would underline that the existing governance framework should be leveraged as much as possible, rather than establishing a specific oversight framework towards ESG risks. We note that institutions' internal governance and control guidelines already include specific instructions that affect the whole entity and should therefore be enough. Institutions should be granted the flexibility to choose the way they internally consider ESG factors, based on their specific circumstances.

We also agree with the proposed Guidelines on the importance of training management on ESG factors and risks, but would stress that this should not be interpreted as a determining factor in terms of management suitability.

Similarly, it would be helpful for the EBA to explicitly set out that the incorporation of ESG within a firms' internal risk management framework does not require that ESG factors be carved out separately.

While we do not disagree with the overall meaning of this section, i.e. that institutions should incorporate ESG risks into their internal control framework across the three lines of defence, our concern is that the delineation of the areas of responsibility between the first and second line of defence (paragraphs 52 and 53) and in particular the assignment of specific responsibilities to the compliance function (paragraphs 52(b) and 52(c)) is overly prescriptive and does not sufficiently take into account that firms may already have pre-existing internal structures whereby the remit of the 1LoD / 2LoD and/or individual 2LoD functions is set out. Consequently, the proposal as currently drafted would oblige institutions to reorganise such existing structures for the purposes of managing ESG specific risks, which may have adverse consequences for the clarity of the structure across the organisation and the institution's resulting ability to manage both ESG and non-ESG risks on a holistic basis.

In particular, we consider that assigning the responsibility for adherence to applicable ESG rules and regulations solely to the compliance function (paragraph 53(b)) may challenge the principle of the ownership of risk arising from business operations residing within the 1LoD, as well as limit the ability of other 2LoD function with appropriate functional expertise to have adequate input and accountability in the adherence process, both at the implementation and ongoing compliance stages. Equally, we consider that assigning responsibility to the compliance function for the provision of advice on operational (incl. legal, reputational and conduct) risks in relation to ESG (para 53(b)) broadens the remit of the compliance function in the ESG context beyond that applicable to the function in relation to the management of non-ESG risk, and has the potential to blur the distinctions and/or create gaps between the respective remits and areas of functional expertise and responsibility within relevant 2LoD functions.

Additionally, we consider that singling out the compliance and risk management functions in the context of new product approval or material amendment (paragraph 53(c)) may lead to the narrowing of existing functional engagement and responsibility matrix in relation to product approvals where individual institutions may have a pre-existing structure comprising a broader set of functional approvers, and/or it may transfer responsibility for assessment and decision-making for risks relating to ESG-related products to the compliance function in the absence of adequate subject matter expertise and/or functional remit.

In relation to the EBA's proposals set out in paragraphs 52 and 53, we would therefore recommend setting the requirements at a higher level, affirming the principle of risk ownership within the 1LoD and alignment with existing functional remits in the 2LoD (for example by requiring that 'firms must ensure' or 'firms must designate appropriate internal control function(s)' to discharge the responsibilities set out in paragraph 53, without reference to specific named functions at the guideline level).

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

We would highlight that currently only those ESG risks assessed as material are incorporated into institutions' ICAAP assessment, specifically in relation to climate scenarios. Therefore we consider that institutions would be able to provide the methodology and description on how these risks are captured in their ICAAP. We would also stress that ESG risk drivers should be approached in the same manner as other financial risk drivers, when institutions run their ICAAP process.

Given ESG risks are not material to all types of financial risks, these will not be fully fledged in the ICAAP – this supports our view that institutions should be able to take a proportionate approach to how they approach the

integration of social and governance risks into their risk assessment and management frameworks. In addition, we would qualify that we do not think that the range of Banking Book exposures can be equally covered in terms of risk assessment (for example, retail exposures compared to real estate exposures). Therefore, we think that it would be premature to back these risks with internal capital in most circumstances.

In terms of terminology, paragraph 55 sets out the requirement for institutions to incorporate material effects of ESG risks into their ICAAP and ILAAP under both the economic and regulatory perspectives. It would be helpful for the EBA to clarify whether the regulatory perspective here means normative in line with ICAAP guidelines.

The requirement under paragraph 58 for firms to conduct environmental risk scenario analysis as part of their ICAAP will be extremely challenging for firms to deliver without additional guidance from the EBA. From prior experience in relation to climate risk, scenario analysis was based on NGFS and ECB scenarios, for which the environmental equivalents do not yet exist. We would encourage the EBA to align any expectation for associated scenario analysis with the availability of relevant scenarios, such as the nature scenarios expected to be developed by the NGFS.

We would also flag that a complete integration of ESG risk drivers into the ICAAP would be difficult, given that the time horizons analysed within this process are shorter than the expected materialization of ESG risks (physical and/or transition risks).

In relation to the EBA's proposals on integrating ESG risks into institutions' ILAAP, we consider that these are premature, given the lack of developed methodologies to assess the impact of ESG risks on institutions' liquidity profile and the relatively lesser material impact compared to institutions' capital profile. Lack of information is a significant obstacle, particularly in relation to social or governance risks. The EBA should therefore clarify whether it expects institutions to adopt a similar approach towards the integration of ESG risks into institutions ICAAPs and ILAAPs.

Finally, we would encourage the EBA to clearly and specifically set out how ICAAP and ILAAP requirements align with the SREP methodology, to avoid institutions needing to duplicate these assessments.

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

We think that institutions should only be required to monitor those portfolios deemed material in respect of physical and transition risks, and track their evolution over time.

The development of quantitative models for ESG risk drivers beyond climate is likely to not be possible at this stage given the lack of both historical and current data. In line with our comments on early questions, we would propose that the EBA take a phased approach, initially focussing on climate risk drivers, and incorporating other risk drivers as data and methodologies develop across industry.

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?

One general point is that consideration should be given to potential unintended consequences of policies that may eventually restrict finance in sectors and countries that are likely to require additional capital for

transition and adaptation. For example, ESG risks may be generally considered to be higher in emerging markets, but for example, Sub-Saharan Africa already has the least access to climate and adaptation finance.

We consider that the proposals in paragraph 67 seem quite broad in scope, and would recommend that these be refined in line with institutions' materiality assessment and the proportionality principle, particularly on how institutions should be expected to prioritise their risk assessment across the range of financial risk stripes, based on their business models and ESG risk materiality assessments.

We would also recommend that the EBA provide further guidance on how risks such as reputational risk should be considered within institutions' transition plans. We agree that reputation risks and legal risks could be mitigated by targeted policies and in embedding ESG topics in processes and risks management frameworks. However since those risks (greenwashing/ social washing) are new, we would highlight that institutions do not have access to historical data to quantify those risks.

In paragraphs 53 and 63, we note that reputational risk seems to be included within the scope of operational risk in the draft Guidelines, which is not aligned with the CRR3 definition of operational risk (which excludes reputational risk). Therefore, we would suggest deleting these references to reputational risk in the Guidelines.

We would highlight that in relation to market risk, the valuation of ESG risks is determined through the official accounting regulation IFRS13, through which the impact of ESG-related factors in derivative pricing is already accounted through available market quotes. In relation to the impact of ESG factors on market risk capital metrics, we would consider stress tests metrics to be the most suitable indicators.

Regarding market risk, we believe that market pricing has increasingly embedded ESG risks in the context of trade pricing and market risks. Market practitioners need to closely understand the products and markets in which they trade to ensure they can effectively price risk.. Recent examples include efficiency in cocoa market, credit analysis on Thames Water (due to water pollution), credit analysis on EDF (during 2022 heat dome), and business re-calibration triggered by Storm Uri (the Texas icepocalypse). These indicate how ESG risks are 'priced into' markets, and can therefore be captured through existing market risk approaches. The inclusion of ESG factors into a risk appetite framework or the IMA stress test would not be appropriate.

As we responded to Q14, in relation to liquidity risk, the lack of data is a significant obstacle to the integration of ESG risk drivers into institutions' risk management framework. We also note that the consideration of liquidity and funding risks is already included in the ILAAP evaluation, so we would underline the need to avoid any duplication requirements.

Regarding operational risk, we note that institutions' internal taxonomies already have a "natural disaster" label. Within this label it is extremely difficult to differentiate between natural disasters that are directly caused by environmental factors and those which are not (and are driven by cyclical factors).

With respect to concentration risk, we note that it is extremely difficult to define concentration risk in relation to ESG factors. Using some of the proposed metrics (GHG emission, sectoral vulnerabilities) would produce an incomplete and wrong picture, as institutions will still have to finance the transition of carbon-intensive firms. We also note that concentration risk (and the management of ESG concentration risk in particular) is already integrated in institutions' internal risk management framework – however we would strongly recommend that this aspect of institutions risk management should not be extrapolated for prudential risk requirements or disclosure purposes. The assessment of concentration risk across all ESG risk drivers is further complicated

by the lack of historical data. In line with our other comments, we would recommend that the requirements focus on climate risk initially, and that requirements in relation to other ESG risk drivers be developed as data and methodologies improve across industry.

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

The EBA should consider that ESG-related risks are not standalone and often exacerbate other macro-economic variables. For example, it is not currently possible to attribute the economic impacts of climate change as distinct from other macro-economic variables. We would suggest that more research & analysis is needed to understand the nature of historical losses related to ESG risks.

Regarding the EBA's proposals around the mandatory use of ESG risks indicators in Section 5.8, we do not think such indicators should be considered mandatory in the finalised Guidelines, but instead should be considered for reference by institutions. Instead of stipulating prescriptive monitoring requirements (e.g. specific NACE codes), the Guidelines should provide institutions with the flexibility to choose the metrics that they judge most appropriate for assessing ESG risks.

We would highlight that the EU Taxonomy Regulation was not designed as a risk management tool and we do not consider that taxonomy alignment ratios should be included as a mandatory risk metric. The EBA and European Commission have acknowledged that there are shortcomings in the Green Asset Ratio and we do not consider that it is a meaningful KPI. The GAR gives rise to several usability challenges and issues with its calculation methodology, which makes it a less reliable or useful metric for investors or other stakeholders to assess the progress of a bank in financing the sustainability transition.

The lack of symmetry between the numerator and the denominator in the GAR leads to a lack of comparability of its disclosures amongst banks. This asymmetry is due to the fact that while the numerator comprises taxonomy aligned activities in the scope of CSRD, the denominator counts instead the total assets independently from the scope of CSRD, including, therefore, assets that cannot be eligible for the EU Taxonomy and will never be taxonomy aligned. Different banks have different business models and the current GAR formula does not enable meaningful comparison against banks as different banks have different proportions of taxonomy eligible activities on their balance sheet. The ratio is significantly impacted by factors such as the proportion of business in sectors covered by the EU Taxonomy, the services that they provide (including the proportion of retail counterparties on their balance sheet) and the proportion of their balance sheet outside the EU (which is unlikely to be eligible for the EU Taxonomy). The asymmetrical treatment of derivatives in the GAR ratio is also an issue that needs refining.

In addition, the GAR only captures taxonomy-aligned activities. It therefore does not adequately capture financing of activities that contribute to the transition and fall within the European Commission's definition of transition finance, but which are not currently aligned with the EU Taxonomy.

Furthermore, there is limited data available on the taxonomy alignment of counterparties' economic activities, and it would be helpful if the EBA could clarify whether these metrics can be determined based on only reported values, or also on estimated values.

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?

Please see our comments to Q1 above. There remains a lack of clarity over the envisaged role of plans under Article 76(2) CRD. It is important that the guidelines clarify this and maintain focus on risk management and have regard to information that banks will already be reporting at group and entity level, including under CSRD. Please refer to our previous comments with reference to the EU Climate Law.

We think it is important to note that the draft Guidelines do not appear to consider prudential transition plans for publication as part of Pillar 3. We do not think that it would be appropriate to consider a public disclosure approach, given the sensitivity of such plans.

We would query the references in the draft Guidelines which appear to envisage the inclusion of "objectives" and "targets", for example, in paragraphs 77 and 85. It is also unclear why plans would necessarily include "actions with regard to the business model and strategy of the institution that are consistent with the plans disclosed under [CSRD]". While we understand the need for banks to consider risk management actions that may be appropriate, this is an example of an area where the draft Guidelines appear to envisage the plans to include objectives and targets such as decarbonisation or reducing the institution's impact on ESG factors. Such an extension could go beyond the mandate of understanding and appropriately managing ESG risks to mandating changes in institutions' business models through prudential regulation.

We would recommend that the EBA provide definitions for general terms such as "targets", "metrics" and "institution" throughout the Guidelines (including how the reference to 'targets' aligns with CSRD reference to expected targets). It is also not clear in paragraphs 91 and 94 whether targets should be set at the (local) Legal Entity level or at the parent company level, which might reside outside of the EU.

We would also underline that the proposed approach would be difficult to implement in respect of non-EU exposures, given that these may have different transition timelines and less data is likely to be available. We would also highlight that the CSRD permits the disclosure of ESG information at consolidated level, meaning that institutions may not have available information at counterparty level. Further clarification from the EBA would be needed here to ensure a workable approach for global banking groups. Again, we note that in relation to the requirement in para 76 to align with EU climate law objectives, it will be hard for institutions to comply with the 1990 baseline, given the lack of access to portfolio data. This question becomes more pronounced regarding the "S" and "G" elements of ESG transition plans, and it would be extremely helpful for the EBA to clearly define what the wider context of the social and governance changes over these time horizons should be assumed on which to base these assessments.

As discussed in our response to Q1, we believe that it is unnecessary to set a blanket minimum of a 10-year long-term time horizon across all elements of ESG transition planning. While the EBA may have determined that this time horizon is appropriate for climate and environmental factors, there seems little or no reason for this to be applied for social and governance factors as well. Given the lack of explanation of the nature of social and governance risk factors which are expected to materialise over this time frame, we would propose that the EBA explicitly clarify that the 10-year minimum for long-term time horizons is specific to climate and environmental considerations, and that firms may assess the appropriate timeframe over which other Social and Governance factors should be planned for. Should further insight as to the appropriate timeframes for these factors emerge as authorities' and institutions' progress further on Social and Governance factors, this could be incorporated into the Guidelines as part of the regular updates to reflect progress made proposed in Article 87a (5) of the CRD.

In addition, we would recommend aligning the time horizons for ESG transition planning with the time horizons mandated in the CSRD. Short, medium- and long-term horizons for CSRD reporting purposes are defined in ESRS 1 Article 6.4. Given the proliferation of various guidelines for target horizons (the CSRD approach differs from, for example, the approach of the NZBA), the EBA should align the time horizons with the CSRD to avoid contributing to confusion.

For paragraph 80, the adverse scenario should be the same as used by institutions in their internal stress tests under scenario analysis. We would recommend that the EBA confirms that the results of those worse case scenarios shall not be taken into account in capital ratios (ICAAP). Additionally, we would appreciate the EBA's additional clarification that the reference to ",*including by assessing in adverse stress scenarios risks arising from current or future misalignment with the institution's targets*", is stated in relation to institutions' own targets and not other political targets/ objectives.

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

As discussed above, we do not believe that it is appropriate to require institutions to assess the soundness and public credibility of their counterparties' transition plans. While institutions perform due diligence on the information they are presented with, they are not well positioned to make a credibility assessment, and would place a disproportionate responsibility on banks for the following reasons:

- Institutions are not liable for the financial statements of their counterparties, even though they assess them in detail; if there are errors in the data, it is the company itself which is responsible.
- Institutions cannot be held responsible for engaging counterparties to develop transition plans, especially when in the case of non-EU counterparties. This is particularly relevant when operating in third countries and with smaller companies (compared to large corporates) and may present competitiveness implications for European institutions vis-á-vis institutions from other jurisdictions who would not be subject to these requirements.

We also note that the transition plans published by counterparties under CSRD (audited by an external auditor) will gradually improve the transparency on counterparties' transition plans.

In line with our feedback on section 5.4 / Q13, we do not disagree with the overall principle that institutions should integrate ESG risk across the three lines of defence, including via an appropriate assignment of roles and responsibilities. However, we consider that assigning the responsibility for setting risk limits within the risk management framework solely to the compliance and risk management functions (paragraph 86(b)) may require institutions to change their pre-existing organisational structures and processes. In particular, a broader set of functional inputs and responsibilities may already be in place for the purposes of the management of non-ESG risks, in line with defined functional remits. In particular, the compliance function may not have the technical expertise and/or the functional remit to ensure alignment between risk limits and the institution's wider prudential transition plan. The assignment of this responsibility to the compliance function may therefore have adverse consequences for the clarity of the structure across the organisation and the firm's resulting ability to manage both ESG and non-ESG risks on a holistic basis. We would propose that the EBA only require the embedding of ESG risks within the three lines of defence, and allow institutions to do so in the way which best fits their own structure.

In line with our feedback on section 5.4 / Q13, we would therefore recommend that institutions should instead be required to integrate their responsibility for aligning their risk limits and the institution's prudential transition plan into their existing controls structure – for example by requiring that 'firms must ensure' or 'firms must designate appropriate internal control function(s)' to discharge the responsibilities set out in paragraph 86(b), without referring to specific named functions.

Paragraph 94(c) requires firms to use metrics on the amount and / or share of income related to business with counterparties operating in sectors that highly contribute to climate change. This does not allow firms to consider counterparty-specific factors such as whether an individual counterparty is best-in-class, or counterparties' transition plans. Further, it does not consider the nature of the exposures, for instance if an exposure is related to helping the transition of a counterparty operating in a sector which highly contributes to climate change. This could also lead to firms seeking to minimise these exposures, which could reduce funding to those counterparties which most need support for the transition.

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?

It is important to clarify how the EBA sees the relevance of metrics and targets from a risk management perspective. As per our comments under Q1, it is important to ensure that the Guidelines are focused on the management of ESG risks rather than functioning to require or pressure institutions to reduce financed emissions, for example. We would recommend that more flexibility regarding the selection of metrics should be granted to institutions, which is over prescriptive as currently drafted.

We believe that the target setting on a technology basis as prescribed in paragraph 91 is too detailed and related to significant data quality and availability uncertainties. A drill down of targets should be aligned with the institutions business model, size and exposure. We also do not agree with the targets for a 3-year horizon as outlined in paragraph 92. Institutions use different time horizons definitions and also room for manoeuvre in a short-term horizon is limited and many institutions set intermediate targets with a target year around 2030. Therefore, we would argue for more flexibility regarding intermediate targets.

In relation to including ESG-related concentration risks, we note that the proposals do not only refer to climate risk but also to additional risks, which may not be achievable by 2026 – we therefore think that the EBA should consider some form of phased implementation.

Paragraph 94(c) requires institutions to use metrics on the amount and / or share of income related to business with counterparties operating in sectors that highly contribute to climate change. This does not allow institutions to consider counterparty-specific factors such as whether an individual counterparty is best-in-class, or counterparties' transition plans. Further, it does not consider the nature of the exposures, for instance if an exposure is related to helping the transition of a counterparty operating in a sector which highly contributes to climate change. This could also lead to institutions seeking to minimise these exposures, which could reduce funding to those counterparties which most need support for the transition.

Regarding the percentage of "positive outcomes" in relation to transition plan engagement, we note that institutions' ability to progress this would depend on the methodology used by individual institutions. A binary outcome may not always be possible. Therefore, it may be more appropriate to monitor progress over time against individual institutions' transition plan assessment methodologies.

The proposed assessment of ESG-related concentration and reputational risk metrics under paragraph 96 c and d could be read to require the establishment of consolidated metrics for ESG as a whole. It would be helpful for the ESAs to clarify that environmental, social and governance risks should be captured separately for these metrics.

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?

We note that institutions should be given flexibility to identify and select the climate and environmental scenarios and pathways which best fit their geography and business model. We understand the list of scenarios in paragraph 97(a)-(d) of the consultation paper to be a representative list and not a mandatory requirement to use all of the scenarios and pathways listed; for example, the consultation paper does not mention the scenarios used for the EBA Fit-for-55 exercise or the NGFS climate scenarios.

The publicly available scenarios quoted in the draft Guidelines do generally not provide regional breakdowns (these are typically global scenarios). Reflecting geographical aspects and granularity will require the consideration of additional or alternative scenarios. In relation to paragraph 98, we would highlight that the Guidelines should acknowledge the potentially significant amount of information required to fulfil these requirements, and should therefore consider a phased approach to implementation.

With regard to the incorporation of EU climate policy objectives in an institution's transition plan definition and target setting, we would flag that this may not be straightforward for portfolios/ sectors containing a significant proportion of global companies with significant operations exposed to different climate policy contexts. We would recommend that the Guidelines provide for flexibility in these cases.

In addition, we note that the reference to "risk management" and "strategic steering" as different use cases for climate scenarios and pathways would require institutions to also consider "real-world" projections of decarbonisation trajectories in addition to "normative" pathways (such as the IEA NZ Emission scenario).

Question 22: Do you have comments on section 6.5 – transition planning? 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? 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? 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. Question 26: Do you have other comments on the draft guidelines?

Q22: Please see our comments above.

Q23: We think that the EBA has adopted a mixed approach in relation to the granularity of the draft Guidelines. For example, in many areas the Guidelines are drafted in a way that the institutional objective and framework is clearly defined, while still providing sufficient flexibility for institutions to account for business model or exposure specific characteristics. However, in other areas of the draft Guidelines, the EBA appears to have

over-specified requirements on institutions (such as the ESG risk metric), which may constrain the ability of institutions in terms of practical implementation. Please see our comments above.

Q24: We do not consider that a common format or template for CRD plans would be appropriate. It is important to provide institutions with flexibility on the format of plans.

Q25: Please see our general comments above. We are concerned that the required data points set out in the draft Guidelines would constitute a burden for institutions, in terms of quantity, quality and availability. Excessive specification and granularity of requirements would increase complexity and cost for institutions, without proportionately contributing towards the achievement of effective ESG risk management outcomes. Instead, we would recommend that that institutions should be provided with the flexibility to focus on the most relevant indicators in relation to their specific business model and strategy. We believe that the priority for the EBA should be on setting the key areas for institutional focus, standardising requirements as far as practicable and setting out clear definitions/ classifications to support the effective implementation of the proposed Guidelines.

Q26: As the EBA has already flagged that the finalised Guidelines will be eventually integrated into the SREP Guidelines, we would emphasize that institutions should not expect to have to meet a secondary set of supervisory expectations on top of the current requirements as presented in the draft Guidelines. As we have emphasised in our response, it is imperative that institutions have the flexibility to approach the implementation of the Guidelines in a way that is proportionate to the material ESG risks they face in the context of their business model and strategy. It would therefore be inappropriate to enable supervisory gold-plating on top of the finalised Guidelines.

As discussed above, it is important that the EBA and other EU authorities remain closely engaged with the current work of global standard setting bodies (e.g. BCBS, FSB) in relation to transition planning and its links to the prudential framework. EU requirements should be interoperable with future international standards, which may require this may require future revisions to the EU approach.

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