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*Submitted via website portal and electronic mail*

**Re: Consultation Paper on Draft Guidelines on the management of ESG risks**

Dear Mr. Campa,

The Institute of International Finance (IIF) appreciates the opportunity to provide public comments to the European Banking Authority (EBA) on Consultation Paper on *Draft Guidelines on the management of ESG risks* ("the consultation").[1] The IIF is the global association of the financial industry, with around 400 members from over 60 countries, including commercial and investment banks, asset managers, insurance companies, ratings agencies, market infrastructure providers, and professional services firms.

Our feedback is structured into thematic comments related to the consultation proposals and specific consultation questions. Section A provides overarching comments on the draft Guidelines; Section B provides comments specifically on the proposals that relate to bank transition planning, or "CRD-based transition plans" as referred to in the consultation;[2] and Section C provides comments on the proposals related to ESG risk management standards.[3]

## A. Overarching comments

IIF members emphasize that the EBA Guidelines should be fully grounded in a risk basis which is aligned with the prudential mandate of the EBA and European banking supervisors. In practice, this means having a focus on potentially material risks to a bank's safety and soundness from ESG-related risk drivers. This would be aligned with the approach taken at the international level by the Basel Committee on Banking Supervision (BCBS) in their 2022 *Principles for the Effective Management and Supervision of Climate-related Financial Risks*[4] (hereafter the "BCBS Climate Principles"), which treat climate-related risk as a driver of the traditional financial risk types.

A significant novel step in the draft Guidelines compared to climate, environmental or ESG-related risk management guidance that has been developed before in the EU or by other jurisdictional

[1] https://www.eba.europa.eu/publications-and-media/press-releases/eba-consults-guidelines-management-esg-risks.
[2] Largely discussed in Chapter 6 of the consultation document.
[3] Largely discussed in Chapters 4 and 5 of the consultation document.
[4] https://www.bis.org/bcbs/publ/d532.pdf.

authorities is the detailed discussion of bank transition planning. As discussed in Part B of this letter, it is extremely important that the right tone and approach are achieved in this area which is receiving much attention from supervisors and other stakeholders at this time, and can often lead to misunderstanding on the role of climate-related transition planning in relation to bank risk management (a topic the IIF discussed at length in a 2023 report[5]).

The treatment and relevance of financial institution transition planning is currently an area of active discussion and analysis at the level of global standard setting bodies and other global supervisory forums, including the Basel Committee on Banking Supervision (BCBS), Financial Stability Board (FSB), International Organization of Securities Commissions (IOSCO), and Network for Greening the Financial System (NGFS). Given that the EBA's mandate in this area does not require the publication of these specific guidelines until 18 months following the entry into force of the CRD, IIF members would suggest that the EBA uses the allowed time to engage with other authorities globally and work towards a more aligned approach to the treatment of, and expectations for, bank transition plans in a prudential context. The EBA could conduct further consultation on the transition planning element in its draft Guidelines later to reflect international developments.

IIF members generally agree with the EBA's intention of taking a principles-based approach in the GL, e.g. "these guidelines focus on processes and principles … while leaving flexibility and responsibility to institutions as to specific details and individual internal strategies." (Chapter 3, para. 19). We think that certain aspects of the proposed Guidelines could be revised so that this is applied consistently throughout, and highlight these areas in Sections B and C.

IIF members support the general proposed approach to materiality assessment described in Chapter 4, para. 12 which focuses on financial materiality and states that "(t)he ESG risks materiality assessment should be performed as an institution-specific assessment which should consider the potential effects of ESG risks on all conventional financial risk categories to which institutions are exposed, including credit, market, liquidity, operational, reputational, business model and concentration risks." However, it is worth noting that the transmission channels to some of these risk types may be less materially affected than for others and, as such, banks should be able to focus on impacts on the risk categories which are likely to be the most material (for example, many banks assess more material impacts to credit and operational risk from climate-related risk drivers, whereas impacts on liquidity, funding and concentration risks may be less materially impacted).[6] Members agree with Chapter 4, para. 15 which states that "(t)he materiality assessment should use a risk-based approach that takes into account the likelihood and the severity of the materialisation of the risks." However, it may be helpful in Chapter 3, para. 2 for the EBA to clarify that they are referring to consideration of 'second-round effects' in the assessment of financial materiality rather than a double materiality assessment (the current term 'environmental and social materiality' may be ambiguous).

However, IIF members do not agree that exposures should automatically qualify as materially subject to environmental transition risks primarily on the basis of their sector (paras.16-17). The proposed specification is highly granular and includes hundreds of NACE codes. Under the

[5] IIF 2023, "The Role of The Financial Sector in the Net Zero Transition: Assessing Implications for Policy, Supervision and Market Frameworks". Hereafter referred to as "IIF (2023)".

[6] A 2022 Global Association of Risk Professionals (GARP) survey of 62 firms, 38 of which were banks, found that "Almost all banks consider climate risk in credit risk and operational risk; around three quarters consider it in reputational and business/strategic risk; and 50 to 60% consider it in legal risk, liquidity risk, and market/traded risk."

proposal, firms 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, creating a significant data and assessment burden even when it is qualitatively obvious that the NACE sector in question poses no environmental risks to the firm.

Similarly, IIF members do not think that banks should have to refer to the EU Taxonomy to identify sectors and therefore exposures as materially subject to environmental risk, as the EU Taxonomy is not a risk management tool, or to rigidly refer to a counterparty's alignment with different net-zero pathways in order to quantitatively assess financial risk to the bank from doing business with that counterparty. While these could be inputs to a bank's decision making, it is necessary to put them into context to understand the likelihood of the characteristics causing the bank material financial loss. The EU Taxonomy was not developed on the basis of evidence of a link to financial loss – indeed, 'green' exposures could be unprofitable, while 'brown' could be profitable over the time horizon of a bank's exposure – and the focus of the EU Taxonomy is on defining 'green' economic activity rather than transition activity.[7]

We urge the EBA to consider whether certain of its proposals could generate an unlevel playing for banks subject to the final GL. For example, applying certain stringent requirements *if not based on a strong risk foundation* may make EU banks less attractive financial intermediaries than non-EU banks (e.g. because of requirements to adjust financial terms or pricing, or to adjust lending and investments in certain ways).[8] The IIF advocates for a risk-based, principles-based approach to climate and broader ESG-related risk management in all jurisdictions to avoid such level playing field concerns.

Finally, IIF members would strongly encourage the EBA to take a sequential and phased approach to implementing the final Guidelines. While progress has been made in recent years by banking institutions on the integration of climate-related financial risks into their wider risk management frameworks, the understanding, measurement, and management of other environmental risks (such as biodiversity and nature-related risks) and social/governance risks is less advanced among both banks and authorities. Even within climate-related risks, there is still a need to develop greater understanding of certain risk transmission channels (e.g., to the trading book).

## B. Comments on Climate Transition Planning expectations

As noted in Section A, IIF members would suggest that the EBA uses the time allowed in the CRD to engage with other authorities globally and to work towards a more aligned approach to the treatment of, and expectations for, bank transition plans in a prudential context. The EBA could conduct further consultation on the transition planning element in its draft Guidelines later to reflect international developments. Nevertheless, in the following paragraphs we have provided some feedback on the draft proposals in the current consultation in order to guide the EBA's continued consideration of these complex and new topics.

### (i) Defining climate transition planning and transition plans

IIF members welcome that the EBA is seeking to differentiate between the non-prudential climate transition planning requirements embedded in the EU's Corporate Sustainability Reporting

[7] See IIF/WTW 2023, "Emissions Impossible: Quantifying financial risks associated with the net zero transition" for greater discussion and examples.

[8] For example, the transition planning expectations or certain risk management expectations (e.g. Chapter 5, para. 42).

Directive (CSRD) and the proposed Corporate Sustainability Due Diligence Directive (CSDDD) from Capital Requirements Directive (CRD)-based plans.

However, beyond the introductory chapters of the consultation, there could be confusion among some readers and stakeholders about the important distinctions between the two as the mere terminology of "TP" in a risk context is confusing. The final Guidelines could be clarified to ensure that duplicative requirements for transition planning are avoided in the EU context.

As set out in IIF's 2023 comprehensive report on transition planning,[9] global financial institutions consider transition planning to be a dynamic business exercise to operationalize a firm's strategic targets and commitments to achieve its low carbon goals. Transition planning is inherently strategic in nature, given that it reflects a financial firm's competitive positioning to navigate key business model risks and opportunities arising from the broader transition of the real economy. Transition planning can produce internally relevant information, as well as some externally relevant information of interest to investors and the wider public (for example, in cases where a firm has made a relevant public commitment). The externally relevant aspects of a firm's current transition planning process can be summarized as a point-in-time disclosure with a forward-looking perspective, which is often what is referred to as the transition plan (for example, in the context of disclosure frameworks or requirements). In this regard, transition plans can inform market actors about a firm's competitive positioning in relation to business opportunities and strategic risks. However, the forward-looking nature of transition plans—and the wide range of exogenous factors beyond the control of financial firms—implies a high degree of uncertainty about contingencies which may affect transition goals.

Given that many banks consider climate transition planning as a strategic process which generates a single climate transition plan, with public and non-public elements, IIF members would like flexibility to consider the interactions between their strategic transition plan (which in the EU is also informed by the CSRD and CSDDD) and climate/ESG risk related expectations. Therefore, IIF members would like the EBA to clarify that firms can leverage their existing risk management processes to determine how best to fulfil any future EBA guidelines on CRD-based plans. Banks would then be able to incorporate the CRD-based plans into their broader transition planning if appropriate, having given due consideration to their unique business model and risk appetite. For example, some banks may choose to include a (non-public) 'module' within, or added to, a bank's (CSRD/CSDDD) climate transition plan that addresses interactions with prudential risk management by drawing from and/or referencing the relevant components of the bank's approach to ESG risk management. However, other banks may prefer to take a different approach and keep the two processes more distinct, so the above-described 'modular approach' should be an option for banks, not a requirement. As EFRAG has not yet developed its specific standards for financial institutions, EBA and EFRAG should work together to ensure consistency between different expectations, where elements of the CRD-based plans relate to a bank's strategic climate transition planning (see Section B(ii) below).

More generally, IIF members would urge the EBA to use the time it has been granted to develop its guidelines for transition planning, including through engagement with other European authorities and at the level of the global standard setting bodies, to avoid future regulatory and supervisory fragmentation in expectations around bank transition planning.

[9] IIF (2023).

### (ii) Differentiating transition plans as strategic documents

Climate risk management and transition planning are distinct processes that should not be conflated. While financial institution transition planning aims to operationalize a firm's strategic targets and commitments to achieve its low carbon goals, climate-related financial risk management is part of broader financial risk management. Metrics that are being proposed to measure progress towards transition targets or commitments are often different to those being developed to evaluate the impact of climate-related financial risks. While the two activities can interact, some of their fundamental differences are very important in the context of prudential supervision. For example:

- A transition plan is a business strategy tool that firms use to define a net-zero aligned strategy, set interim emission reduction targets and, over time, track progress towards these targets.
    - This exercise may inform risk management processes by helping the bank identify any material risks that it may face along this transition pathway over the short-, medium- and long-term.
- Risk management tools, on the other hand, assist banks in monitoring and enforcing their firm-wide risk appetite.
    - Risk management may therefore be involved in the governance and oversight of a bank's transition plan.

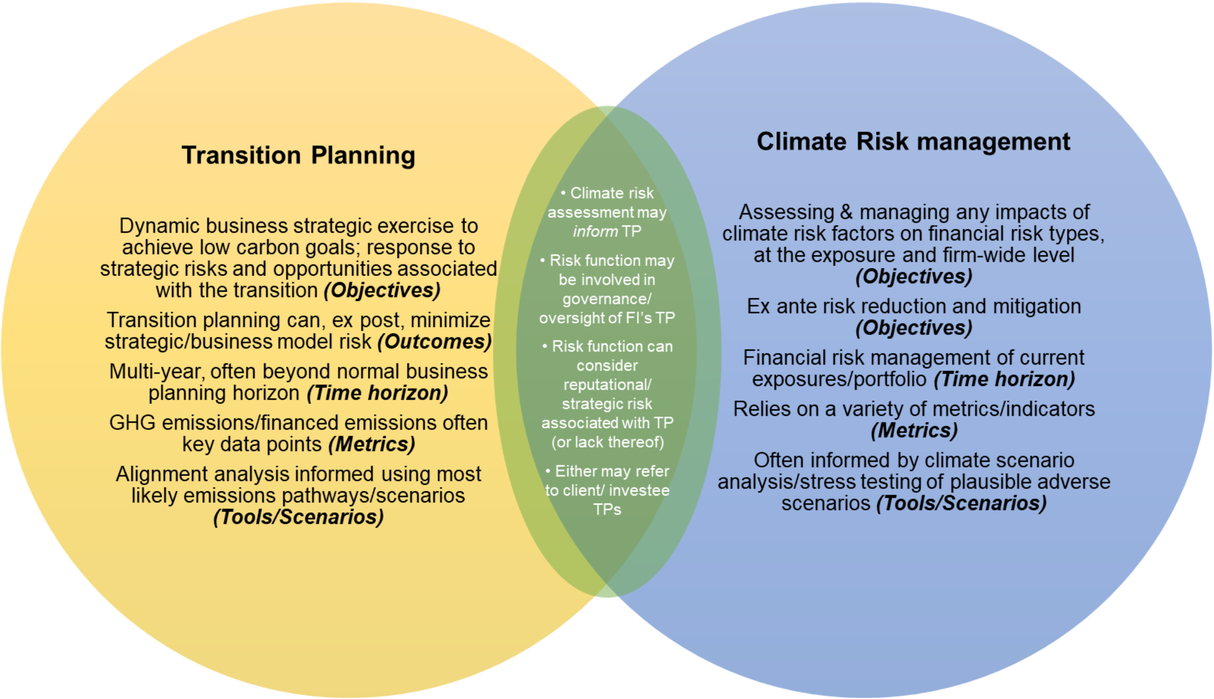
The differences and interactions are summarized in stylized Figure 1. While climate transition planning and prudential risk management may inform each other, they remain inherently distinct exercises which the EBA guidelines should not conflate. This is particularly true in the context of the ESG risk management requirements under CRD, since ESG risk management captures a broader set of risks than those arising solely from a bank's net-zero aligned strategy, e.g. the potential first- and second-round effects of climate change in the value and performance of a bank's assets.

The current draft Guidelines appear to conflate CRD-based transition plans with risk management tools in places. For example, in the following paragraph: Chapter 6, para. 90: "The targets set by institutions should serve risk management and strategic steering purposes with a view to mitigating risks stemming from the process of adjustment towards the legal and regulatory sustainability objectives of the jurisdictions where they operate, and broader transition trends towards a sustainable economy." This conflation can be further seen in the description of governance arrangements, defining criteria for selecting metrics as well as scenarios and pathways, and prescribing the time horizons for target-setting. In the context of transition plans, the choice of sectors, material exposures, time horizons, metrics and targets will be tailored to each plan and the firm's business model. At the same time, not all the sustainability matters presented in CSRD reporting (e.g., financed emissions or exposures to high-emitting sectors) will necessarily constitute material risks for the firm.

IIF members agree that a bank's public commitments related to climate/transition finance need to be supported by appropriate internal planning and arrangements. Bank risk functions do consider implications of NZ targets/commitments as relevant (e.g. risk limits) and to manage reputational and/or legal risk associated with missing targets. But NZ targets are not relevant for capital adequacy assessments – the methodologies/scenarios underpinning each are different.

Finally, financial institutions may choose to refer to the transition plans of their clients, counterparties and investees as part of assessment of their portfolio-level emissions vis-à-vis the financial institution's own net zero targets and associated client engagement. However, banks should not be responsible for assessing the broader 'credibility' of corporate clients' transition plans, which is implied by the requirement to "assess the soundness of at least large corporate counterparties' transition plans". Several dimensions of credibility may be relevant for stakeholders evaluating transition plans, including i) scientific integrity; ii) technological reliability; iii) financial and economic feasibility; and iv) strategic and competitive viability. However, while financial institutions may use information included in transition plans in multiple ways, it is not clear that they as private companies should be seen as solely responsible for evaluating the credibility of other firms' transition plans. Nor would it be practical for financial institutions to do in many cases (e.g. in the case where a bank acts as an agent under a syndicated facility). Considering this, IIF members do not think that financial institutions can be reasonably expected to be wholly responsible for assessing the broader credibility of real economy firms' transition planning, and it goes beyond the remit of a private financial institution to do. Under CSRD, auditors will have to review the compliance of these plans with the European Sustainability Reporting Standards (ESRS) requirements.

Figure 1: Stylized Comparison of Financial institution transition planning & Climate Risk Management




### (iii) Risk scope of transition planning

At this time, banks are developing transition plans to implement NZ strategic targets/commitments, which are related to climate risks, by definition. Therefore, it does not make sense to require transition planning for beyond climate risks.

### (iv) Transition planning approaches

IIF members strongly support the EBA's stated goal of not forcing banks' business strategy through requirements around transition planning. While the financial sector has a critical role to play during the economy-wide NZ transition, its ability to support the transition will depend significantly on whether the conditions are in place to enable the real economy to transition, thereby creating opportunities for finance and investment to support such activities. Over-reliance on the financial sector and its regulators to deliver the net zero transition risks diverting attention from the fundamental policies needed to catalyze actions across the entire economy.

Related to this, the EBA Guidelines should not prescribe business strategy in relation to transition planning, and should be focused on any risk implications or interactions. However, IIF members are concerned that some of the proposed requirements in the draft Guidelines are overly prescriptive. For example, if the EBA requires banks to set targets for certain sectors as described in Chapter 6, para. 91.

The approach to suggesting specific metrics in Chapter 6, para. 94 is over-prescriptive, and the suggested metrics appear to be more generally related to strategic transition planning and not risk management. It may not be necessary for the EBA to specify metrics in this way given their remit. It is not clear how the significant data gathering proposed in the draft Guidelines would aid banks in the assessment of prudential risk. Many of the data items do not have a clear relationship to any prudential risk type, or at least cannot be argued to do so without making significant assumptions about the direction of public policy with respect to the net zero transition. Banks should be given the flexibility to decide which data items they judge most relevant to informing their ESG risk management – for example, the potential reputational risk of certain business activities – based on their own macroeconomic assumptions and knowledge of their specific portfolio exposures and counterparties.

IIF members would like to flag some concerns with the reference in the draft Guidelines to the EU Climate Law. In the context of para. 97, as an indication of one pathway to take into consideration for climate scenario analysis to inform transition planning, the main concerns are technical ones. That law refers to specific milestones and a 1990 baseline which is not workable for banks as they often do not have access to the necessary 1990 portfolio data. We note that for the EBA Fit-for-55 exercise, banks were asked to work with a 2022 baseline. Also, for banks with portfolios that contain a significant proportion of globally-active companies, those exposures are subject to different climate policy contexts and the relevance of the EU policy context would be very limited. Emphasis on a feasible baseline and coherence across initiatives should be applied, with the necessarily flexibility to reflect a bank's portfolio.

However, in other parts of the draft Guidelines, the references to the EU Climate Law are more fundamentally problematic. Banks should not be required to refer to the EU Climate Law, which derives from a political objective for EU Member States, in the context of their risk management requirements. For example, in para. 35 or in para. 76, which to banks having to "manage climate-related risks associated with the objective of the EU to reduce GHG emissions by 55% by that date compared to 1990 level." We recommend removing the references to EU policy objectives in these cases.

In relation to climate and environmental scenarios and pathways, the publicly available scenarios quoted are typically global scenarios which often do not provide a regional breakdown. The ability of banks to reflect geographical aspects and granularity will require the consideration of additional

or alternative scenarios. Further, as indicated by para. 97(b), banks would need to take account of the latest scientific evidence and "real-world" projections of decarbonization trajectories when using climate scenario analysis for strategic transition planning.

Some financial institutions have begun to develop approaches to gather and process client, counterparty or investee transition planning and other transition-relevant information. In theory, the current and forward-looking information contained in a corporate transition plan can be a useful input to a financial institution's assessment of a counterparty's GHG emissions trajectory, adaptive capacity, and potential future competitiveness. In this way, transition plans could serve as an input to a financial institution's client engagement, assessment of business opportunities, as well as assessment of strategic business risk to a counterparty. However, at present, the majority of client and investee transition plans are at early stages of development and often not disclosed and, as such, require significant bespoke dialogue and analysis to engage with and evaluate. They also face challenges around quality and comprehensiveness of counterparty transition plans, and comparability across firms. Due to these current constraints, many financial institutions are limited in the degree to which they can take account of client/counterparty or investee transition planning information in their business decisions today. IIF members would therefore recommend that the provisions related to using counterparty transition plans (e.g., Chapter 6, para. 103) reflect the current realities.

### (v) Publication of transition plans

We support the EBA's approach which does not appear to require publication of CRD-based climate transition planning information. Some banks are beginning to develop public strategic transition plans. However, the content of a CRD-based transition plan would be wider and internal/ confidential in nature. It would be akin to information in a bank's ICAAP, which is shared confidentially with supervisors.

It would also be helpful for the final Guidelines to clarify whether CRD-based transition plans need to specifically submitted to a bank's supervisors, or not.

### (vi) Level of application of the Guidelines and treatment of global and foreign banks

The final Guidelines could be clearer on the intended level of application within a banking group. Most banks are making NZ targets/commitments on a group-wide basis. Banks account for the nature of the transition as they manage their portfolios across the different markets in which they operate. Further, disaggregating metrics and targets at an entity-level is challenging to do and may not provide an accurate view of the bank's group-level strategy, or the risks faced by the bank with respect to that business strategy. Hence it would be more accurate and realistic to permit banks to apply the Guidelines at a consolidated level, notably for the transition plan, metrics and targets elements.

Foreign subsidiaries operating in the EU (with a non-EU parent institution) may or may not have a group-level NZ target/commitments (which are compatible with the EU's objectives). It would be helpful for the EBA to clarify whether foreign subsidiaries would be able to leverage their group-level approach at the level of the EU entity, if they have one, and provide commentary on how EU-regulated entities are affected by the group-level plans (which are beyond the remit of European authorities' oversight).

In general, IIF members support the EBA and other EU authorities remaining closely engaged in the current work at the level of the global standard setting bodies (e.g. BCBS, FSB) on transition planning and its links to the prudential framework. EU requirements should be interoperable with future international standards – this may require revisions to the EU approach in future.

### B) Comments on ESG risk management expectations

IIF members broadly support that the structure of the EBA's proposed ESG risk management Guidelines as these reflect the structure of the BCBS Climate Principles. However, the proposed EBA Guidelines relates to broader ESG risk, although the EBA notes that they are taking a "sequenced approach" by providing some guidance on social and governance aspects (p. 48). IIF members strongly believe that the EBA should take a sequential approach to integrating ESG risks within internal risk management, prioritizing climate-related financial risks and not rushing to include biodiversity or nature-related risks, social and governance risks until approaches are more advanced in those areas. Not only are the available data significantly different between different types of environmental risks, social and governance risks, but they have different transmission channels as drivers of financial risk. Social and governance risks are often relevant in a more idiosyncratic way to specific clients or activities and, as such, can be harder to integrate in a systemic way into risk assessment approaches. IIF members support a sequential and phased implementation approach, which would be appropriate given that measurement and management of broader ESG risks (beyond climate risk) is at an earlier stage of development in the banking industry. This should be recognized in the final standards and the subsequent supervisory engagement.

IIF members would also recommend that the EBA takes a sequential approach to the application of the final Guidelines to trading book exposures, given the higher degree of data and methodological constraints in relation to trading book exposures. Less progress has been made to date on assessing climate-related financial risk transmission mechanisms for exposures held for trading as compared to positions held in the banking book. Positions held in the trading book are actively risk managed and hedged in order to minimize potential financial risk to the bank. Some positions are intermediated on behalf of the bank's clients and, typically, positions are held for very short time horizons (sometimes only minutes) and, as such, may not present a very meaningful reflection of how the bank is exposed to climate-related risk factors. Mark-to-market, which is often used to determine a transaction's financial risk, may not be relevant when assessing the underlying's exposure to ESG risk factors. If the trading book was to be in scope of the final Guidelines, it would be necessary to phase in the requirements to allow time for some of these methodological issues to be resolved and for banks to gather the necessary data given the high volume of transactions which can be typical in the trading book.

#### (i) Identification & Measurement ESG Risks

IIF members do not dispute that climate and environmental factors can lead to financial losses and must therefore be incorporated both in bank risk management and supervisory approaches.[10] However, prudential regulation and supervisors should be focused on ensuring that banks remain safe and sound, including solvent in the face of unexpected losses, rather than being used for

[10] As set out in detail in IIF 2020, "Prudential Pathways" and IIF 2024, "IIF/ISDA Public Comment on the Basel Committee's Consultation on Disclosure of Climate-related Financial Risks" (Section B).

climate policy objectives for which other regulation, such as fiscal measures or environmental regulation, is better suited.

IIF members believe that the Guidelines should take a methodologically neutral approach and not require that banks necessarily use the three types of methodologies outlined in the consultation (exposure-based, portfolio-based, scenario-based). Bank are using a range of risk identification and assessment methodologies to identify any material climate-related, or in some cases broader ESG-related, risk drivers. The BCBS Climate Principles do not prescribe methodologies in such a specific way beyond requiring use of climate scenario analysis. Use of methodologies, if the results are to inform business decisions, need to be chosen by the bank to suit its business model, strategy and risk appetite.

In relation to Chapter 4, para. 30, it is important that there is not undue pressure for banks to adjust internal risk classifications or internal ratings-based (IRB) models for counterparties based on ESG factors given the continuing lack of evidence or sufficient data on which to base such judgements. In general, IRB model specification and parameterization is associated with higher requirements for analytical confidence in terms of time-series data, back-testing, etc. While some banks are reviewing internal risk scores and ratings using expert judgement to account for certain material ESG factors, it is important that there are appropriate expectations for these processes given current data and methodological limitations and the importance of maintaining confidence in internal modeling approaches more generally. The emphasis in para. 30 on making adjustments "where justified by their materiality" is welcome.

Specifically with respect to the exposure-based methodology, chapter 4, para. 33 would require firms to implement due diligence processes to verify counterparties' adherence to social and governance factors. Again, it is not clear how these factors would drive prudential risk aside from (in certain severe scenarios) through reputational or counterparty risk. Absent clear causality, firms should be allowed to make their own assessment of the relevance of these factors to their risk management. Additionally, we believe that the suggested responsibility placed on banks regarding this due diligence is excessive. Banks should not be made responsible for reviewing its counterparties' "adherence to social and governance standards" through their activities or transition plans. This type of due diligence could even result in different outcomes between different banking institutions.

Specifically with respect to the portfolio-based methodology, absent firm-level net-zero requirements, it is not clear why banks should be required to factor climate-related portfolio alignment into their risk management practice. Firms may choose to shift the composition of their portfolio away from certain exposures/sectors to reduce transition risk, but they may equally decide to adopt other risk management strategies that allow them to retain their existing portfolio balance (e.g. through other hedging strategies).

As discussed in Section A of these comments, IIF members do not agree with the reference to the EU Taxonomy to exclude some sectoral activities. Alignment with the EU Taxonomy would not directly imply less ESG risk, and this would also not provide coverage for a bank's non-EU exposures.

We also note that para. 38 requires institutions to measure their impacts on the UN SDGs – we do not think that this is an appropriate objective, given the disconnect with the prudential risk focus of the Guidelines.

### (ii) Data processes and counterparty engagement

Despite significant efforts and investments by many banks across the world, lack of data continues to be one of the biggest challenges that banks of all sizes and in all jurisdictions are working to overcome when it comes to integrating climate/environmental and social/governance risk drivers into their risk management approaches.

Chapter 4, para. 25, recognizes the data gaps currently faced by banks in relation to ESG risk management. Many banks are reliant on proxy data, estimates and third-party data sources for internal purposes and to meet their own regulatory and disclosure requirements. However, more clarity is required on the EBA's expectations around the specific provisions in para. 25 including the timeframe for reducing reliance on proxies, and the expectations around quality assurance for data procured from third party providers. As well as the time required for certain underlying data to become available, banks also need time to build out their data systems to house a variety of non-financial datapoints for their clients and counterparties. Banks should also not be held responsible for potential differences between initial data (whether estimated or proxies) and real data if this subsequently becomes available. It would be helpful for the EBA to provide more guidance on how banks should approach the sequencing of data development around the implementation of the proposed Guidelines in relation to other EU legislative items, such as the CSRD, which is expected to be a key source of data for companies in scope. We also believe that public authorities should invest in making available public databases on factors such as GHG emissions and asset localization.

The proposed requirements for "engagement with counterparties aiming at improving their ESG risk profile" set out in Chapter 5, para. 42(a) appear to overstate or misunderstand the role of banks as financial intermediaries and instead expects them to influence their counterparty's ESG risk profile (which is akin to a double materiality objective). They should also be more clearly worded to reflect a link to the bank's financial materiality assessment (as the reference to a bank's "most important and most critical counterparties" is not very clear).

### (iii) Governance, strategies and business models

It is important that banks are able to leverage their existing firm-wide governance frameworks and approaches for purposes of complying with the final Guidelines. Banks should have the flexibility to account for ESG factors in their internal governance approaches however they think best considering their group structure, portfolio exposures and specific circumstances.

The EBA is currently proposing a prescriptive approach to some of the guidelines on integrating ESG risks across the three lines of defense (Chapter 5, para. 86). However, we appreciate that much of the granularity stems from the level 1 mandate for the EBA to determine the responsibilities associated with development, implementation and monitoring of plans.

The draft Guidelines require that banks should account for ESG risks when developing, formulating and implementing their overall business and risk strategies, including considering insights from portfolio alignment methodologies, environmental scenario analysis, climate or environmental stress tests. Many banks are doing this at present, often with a focus on climate-related risk factors given the relative maturity of knowledge, metrics and modelling. It is important that the EBA is not overly specific in terms of tools banks use for strategic analysis.

Regarding risk appetite (Chapter 5, paras. 46-48), for large and complex institutions, metrics and risk limits/targets are generally specified at the consolidated level. Cascading such metrics to lower levels in the organization may not the most efficient way to make sure the targets set at consolidated level are met, especially for a well-diversified banking group. Moreover, it is important to stress that requiring an undue focus on metrics or limits from the perspective of ESG risk drivers could introduce imbalance or an outsized focus on ESG risks within a bank's broader risk appetite framework. It is important that banks have sufficient flexibility to choose the relevant metrics with a focus on the most material risks to its business model.

In relation to the references to greenwashing in para. 67, we would note that many banks are already developing approaches to identify, prevent and manage risks associated with greenwashing or perceived greenwashing. Institutions are awaiting the final recommendations on greenwashing from the European Supervisory Authorities (ESAs), following the release of the ESAs' respective Progress Reports in H1 2023. The final EBA Guidelines should refer to the final Report(s) on Greenwashing for consistency in case of any interim changes.

Specifically in relation to the references to reputational risk in paragraphs 53 and 63 of the draft Guidelines, the current drafting seems to include reputational risk as a component of operational risk, however that is misaligned with the EU CRR3 definition of operational risk (which excludes reputational risk). We would suggest deleting these references to reputational risk in the final Guidelines for avoidance of confusion.

In relation to concentration risk (para. 68), it is very difficult to carefully define concentration risk in the context of ESG risk factors; there is not currently a well-established definition in the EU or globally. Thresholds for what constitutes a 'high degree of concentration' would likely be needed, including analysis of an appropriate way to define and calibrate such thresholds. Given that the risk assessment process is multidimensional, it is also necessary to avoid unintended consequences associated with reliance on certain characteristics (e.g. some of the proposed metrics in the draft GL, such as GHG emissions) which could indicate that certain sectors or geographies are more or less risky in a way that is too crude and could also significantly reduce transition or development financing to sectors and geographies that need it the most.

### (iv) ICAAP and ILAAP

IIF members agree that material climate and ESG risk drivers should be treated in the same way as other risk drivers for purposes of the International Capital Adequacy Assessment Process (ICAAP). This is consistent with the BCBS Climate Principles for climate-related financial risks. As for other risks, banks should be in control of their approach and be able to describe how they have accounted for relevant material ESG risk drivers in their analysis. The number of risk drivers and factors that are relevant over the time horizon of the ICAAP may be fewer than those identified as part of the broader EBA-required risk identification process which is intended to span a ten-year time horizon. In practice, many banks are already taking steps to reflect climate-related material risks in the ICAAP, but they are often not material over the time horizon of the analysis.

IIF members recognize the relevance of scenario analysis as a forward-looking tool to assess the possible impacts of climate-related risk drivers in the future, given the long-term nature of climate change. However, regarding para. 58, we believe that it is premature for banks to fully integrate environmental risk related-related scenarios alongside the wider economic scenarios used for capital planning and projections, due to data and conceptual limitations applying in the climate space and even more so in relation to other environmental risks.

We would also emphasize that the BCBS Climate Principles, which are more narrowly scoped in terms of risk focus than the draft GL, recognize that "climate-related financial risks will probably be incorporated into banks' internal capital and liquidity adequacy assessments iteratively and progressively, as the methodologies and data used to analyse these risks continue to mature over time and analytical gaps are addressed."[11] This consideration should also be applied by the EBA in terms of recognizing that the ability of banks to capture climate-related risk drivers in the ICAAP exceeds that of broader E/S/G risk drivers, and also that the banking industry is at even earlier stage in terms of understanding the transmission channels to liquidity risks and therefore the ILAAP.

### (v) Monitoring and Metrics

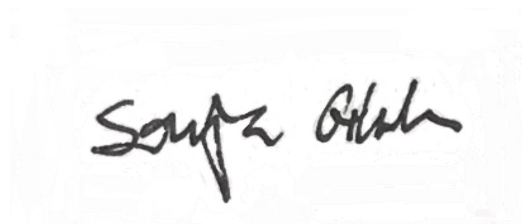
The Guidelines should not be prescriptive on which specific metrics banks should use as risk indicators; the BCBS Climate Principles are not prescriptive in this way recognizing the diversity of potential approaches and bank portfolios, and the data and methodological constraints facing banks.

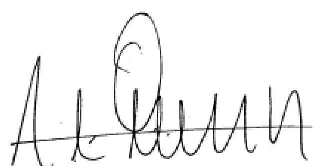
Several of the proposed metrics have not got an evidence basis or track record for being climate-related risk metrics – e.g. GHG emissions, EU taxonomy alignment metrics.

Many banks have significantly invested in developing or procuring and testing certain metrics for internal use and voluntary disclosure purposes, including through some market-based alliances and efforts, and should be able to leverage this work as relevant for purposes of meeting supervisory expectations such as the final EBA GL.

Thank you for your consideration of these comments. On behalf of the IIF membership, we hope that these global industry perspectives will contribute constructively to your efforts, and would be happy to discuss our comments further. We invite you to contact Sonja Gibbs (sgibbs@iif.com) or Andres Portilla (aportilla@iif.com) should you have questions or comments.

Yours Sincerely,





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[11] BCBS Climate Principles, para. 26.