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Response to the European Banking Authority (EBA)'s Consultation Paper on Draft Guidelines on the management of ESG risks

18 April 2024

Executive summary

The undersigned associations wish to respond to the EBA's Consultation Paper on Draft Guidelines on the management of ESG risks (the draft Guidelines). We represent companies headquartered or with significant operations in non-EU jurisdictions, who are deeply committed to, and invested in the EU. We have raised a number of points in our responses, where we believe institutions require greater clarity and flexibility, and which are summarised below.

- **Prudential transition plans:** We call for the EBA to provide further clarity on the interplay of the Capital Requirements Directive (CRD 6) prudential transition plan requirements with other transition planning obligations, in particular those under the Corporate Sustainability Due Diligence Directive (CSDDD), the Corporate Sustainability Reporting Directive (CSRD), and EBA Pillar 3. It is crucial that the EBA clarify how the prudential transition plans can fit into and leverage other transition plan requirements, to avoid duplication of requirements and enable global banks to set out groupwide transition planning and risk management approaches, where applicable. To be clear, we are not requesting any further prescription regarding the CRD 6 transition plan requirement itself. We are seeking an elucidation of the EBA's thinking on the issue of overlap with other requirements (and, at most, illustrative examples of how firms could approach the issue).

  Additionally, regarding the CRD 6 prudential transition plans, we call for the EBA to clarify that EU subsidiaries of third-country groups may leverage and rely on, where applicable, group-level transition plans. Again, such clarification would minimise reporting burdens and maximise interoperability of different transition planning requirements across EU and international jurisdictions.

- **ESG risk management:** We would welcome further clarifications regarding the Guidelines' approach to considering ESG risks and management, as well as setting time horizons. In the broader market, methodologies for the management of climate-related risks are much more advanced compared to other environmental risks, and compared to social and governance risks more generally. We believe the EBA should provide a more adaptable approach and timeline in relation to social and governance risks in particular.

  Institutions should also be granted discretion in determining the materiality of ESG risks under the Guidelines. We do not agree with the Guidelines' approach of linking materiality assessments to specific sectors defined under EU legislation or to the EU Taxonomy. This approach raises a number of difficulties, in particular for institutions with a third-country nexus.

  More broadly, institutions should be able to set their own time horizons and milestones for ESG risk management as part of their prudential transition plans, given not only data issues but also the overlap with time horizons set by other sustainability-related regulations and initiatives.

- **Data, metrics and targets:** Given issues around data availability and quality, which again are particularly acute in a third-country context, we call for the EBA to provide greater discretion for institutions in terms of data processes and gathering, as well as in setting metrics and targets.

- **Application timeline of the Guidelines:** We ask that the EBA clarify the application date and timeline of the Guidelines.

  The Consultation Paper anticipates that EBA plans to finalise the Guidelines by end-2024, and that the application of the final Guidelines will depend on the application date of CRD 6. Additionally, according to Article 87a(5) CRD 6, the EBA shall publish the Guidelines by 18 months from the date of entry into force of CRD 6.

  CRD 6 will need to be transposed by Member States before it starts to apply. According to Article 3(1) CRD 6 (*Transposition*), Member States will have 18 months from the date of entry into force of CRD 6 to adopt and publish the related laws, regulations and administrative provisions necessary to comply with CRD 6. Those provisions shall apply from 1 day after the transposition date.

  In view of the above, our understanding is that the application date for the Guidelines will depend on the transposition and application of CRD 6 into Member States laws. In other words, our understanding is that **the Guidelines will apply from 18 months + 1 day following the date of entry into force of CRD 6.** We ask that the EBA clarify whether our understanding is correct and that the final Guidelines incorporate and specify this application date.

The section below provides our responses to specific consultative questions.

Responses to EBA questions

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?

Interplay with other transition planning requirements: We support the overall approach of the draft Guidelines in seeking to define the interplay between the different requirements on transition planning across various legislative initiatives. In particular, the draft Guidelines distinguish between the strategic transition plan mandated by CSDDD and disclosed according to CSRD rules, and the prudential transition plan requirement set out under CRD 6.

We also support the EBA's comments during its hearing of 28 February that different requirements on transition plans should not result in introducing the obligation to develop multiple plans to fulfil different purposes.

However, we still believe further clarification is needed in this area, in particular with respect to the points below:

- **Interaction with CSDDD / CSRD requirements:** The final Guidelines should further clarify the interaction between the CSDDD / CSRD requirements and the CRD 6 prudential transition plan requirements. This is to avoid duplication of requirements and to ensure banks have the

flexibility to leverage one transition plan and, more generally, an overall strategy on transition planning and risk management. In particular, the final Guidelines should outline (in a non-prescriptive way) how CRD 6 prudential transition plans can build upon and compliment transition plan obligations under CSDDD / CSRD, by addressing relevant climate and other ESG-related risk management aspects. Again, any further prescription regarding the CRD 6 transition plan requirement is not necessary here; rather, the EBA should explain its thinking regarding the interaction of CRD 6 prudential transition plans with other requirements.

- **Group-level transition plans:** We agree with the EBA's approach that the CRD 6 prudential transition plan obligations should apply at an EU entity level only, and not at a wider group level. However, we believe EU subsidiaries – including those of third-country groups - should still be able to leverage from their group-level transition plan, if available, in satisfying their entity-level CRD 6 prudential transition plan obligations. In particular, the EBA should guarantee sufficient flexibility that, where the CRD 6 prudential plan obligations can be satisfied in this way, EU subsidiaries should not be required to present local plans on a standalone basis. Such flexibility will minimise the reporting burden on banks, and will help maximise interoperability with requirements on global banks across multiple jurisdictions.

- **Transition planning and ESG risk management have different objectives which, while they have some interaction, must be treated distinctly by prudential supervisors**. A transition plan is a business strategy tool that banks use to define a net-zero aligned strategy, set interim emission reduction targets and, over time, track progress towards these targets. Risk management tools, on the other hand, assist firms in monitoring and enforcing their firm-wide risk appetite.

- However, as implied by CRD Article 76(2), ESG risk management also 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, and social/governance factors indirectly related / unrelated to climate change). As such, while transition planning and climate risk management inform each other, transition planning and ESG risk management remain inherently distinct exercises which the EBA guidelines should not conflate.

References to EU Climate Law and other EU political measures: Para 13 of the draft Guidelines states that CRD 6 plans should be set "*in view of the process of adjustment towards the regulatory sustainability objectives of the jurisdictions they operate in*", noting that the EU, relevant objectives related to ESG factors include the climate targets included in the European Climate Law. Additionally, para 76 of the draft Guidelines refers to institutions setting time horizons as part of their plans which are aligned with European Climate Law objectives. Para 97 also refers to setting prudential transition plans and targets in light of likely pathways originated from the European Climate Law, as well as the European Green Deal and the latest reports and measures prescribed by the European Scientific Advisory Board on Climate Change.

As drafted, the Guidelines suggest a requirement for CRD 6 plans to be compliant with the European Climate Law and these other EU measures; however, the European Climate Law as well as the other

EU measures referenced are political objectives and are not risk-based. To the extent the Guidelines suggest any such compliance requirement with the European Climate Law or other measures, this could generate unintended consequences from a risk perspective. The EBA should provide a stronger clarification that the focus of the Guidelines and the CRD 6 plans is on prudential risk management only, and there is no requirement for CRD 6 plans to be compliant with the European Climate Law or the other EU measures referenced above.

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.

The draft Guidelines have brought together environmental, social and governance risks in terms of approach and timeline in the transition plan. However, as acknowledged by the EBA during its hearing on 28 February, banks have much more developed methodologies and data for the management of climate-related risks compared to other environmental risks, and compared to social and governance risks more generally. Also, the most widely accepted international disclosure standards currently predominantly cover climate-related risks. Accordingly, definitions, concepts, and metrics on other environmental risks are not yet fully mature leading to potential inconsistencies across frameworks. Moreover, not all social and governance risks are developed or commonly understood to the same standard; additionally, certain aspects are subject to political debates and consequently may not be appropriate to apply in a prudential transition risk context.

Therefore, it is our view that:

- The final Guidelines should recognise more explicitly these different methodologies for the management of climate-related risks compared to other environmental risks, and compared to social and governance risks more generally.

- The final Guidelines should allow for a more gradual approach to the consideration of environmental, social and governance risks and related requirements by institutions, including in the context of setting prudential transition plans. Additionally, the timeline for social and governance risks and related requirements should be separate from, and on a longer timeframe than, the environment risks and related requirements.

  In time, institutions will be able to benefit from more granular information on the environmental, social and governance risks of their counterparties, through CSRD as well as from more advanced methodologies to tackle these risks.

- As highlighted in our response to Questions 4 and 5 below, while we agree that institutions should consider both qualitative and quantitative elements when assessing the materiality of climate-related financial risks, we believe that the assessment of social and governance risks should focus on qualitative elements only and be done on a best effort basis at this stage.

- During its hearing on 28 February, the EBA said it is considering including examples of environmental, social and governance factors to be considered by banks in the final

Guidelines. If the EBA does still intend to do so, the EBA should make very clear in the final Guidelines that these are intended as examples only and not as a checklist of factors that banks are expected to consider.

- The final Guidelines should exclude the trading book, as transactions are considered short term and immaterial. If the final Guidelines include the trading book, the implementation timeline should be significantly delayed. Our response to Question 7 provides additional detail regarding the exclusion of the trading book.

- Further guidance on how to handle interactions between various types of risks from a risk management perspective is not necessary. Large banks can and will continue to develop their own tools to address new categories of risks or risk drivers by integrating them into their own risk management frameworks.

  Similarly, we are not requesting any further prescriptive guidance on the management of environmental, social or governance risk or on timelines. Rather, our ask is that the EBA clarify the points raised above.

Question 4: Do you have comments on the materiality assessment to be performed by institutions? Question 5: Do you agree with the specification of a minimum set of exposures to be considered as materially exposed to environmental transition risk as per paragraphs 16 and 17, and with the reference to the EU taxonomy as a proxy for supporting justification of non-materiality? Do you think the guidelines should provide similar requirements for the materiality assessment of physical risks, social risks and governance risks? If yes, please elaborate and provide suggestions.

Increased flexibility for ESG risk materiality assessments: Individual institutions should have greater flexibility to assess the materiality of ESG risks in their specific portfolios and across their sectoral exposures. All institutions should be able to decide which ESG risks are most relevant to informing their ESG risk management, based on their own macroeconomic assumptions, business model and knowledge of their exposures/counterparties.

Paras 16 and 17 of the draft Guidelines currently provide that exposures to certain sectors, as defined under EU legislation, are automatically considered materially subject to environmental transition risks. Moreover, the draft Guidelines state that institutions may only consider such sectoral exposures as not materially subject to environmental risk where the institutions can justify this, for instance on the basis of a high level of alignment with the EU Taxonomy.

We do not agree with the principle that exposures towards certain sectors should be considered materially exposed to environmental transition risk by default. This principle does not take into account institutions' individual business models or counterparties, nor the specific environmental transition risks that may arise therein. We also anticipate this principle may raise particular issues, including data availability and/or lack of relevance, where institutions have a third-country nexus (such as when facing third-country counterparties).

We also disagree with the approach of allowing derogation from the above principle on the basis of alignment with the EU Taxonomy. There are several issues with this approach. Notably, mere alignment with the EU Taxonomy does not directly imply lower prudential ESG risk, as the EU Taxonomy

Regulation does not classify activities from a transition risk-based perspective, but rather based on whether such activities contribute to specified environmental objectives. The draft Guidelines appear to conflate the two concepts and incorrectly assume that a "high" Taxonomy-aligned exposure poses a "low" prudential risk (and vice versa). However, it is entirely possible for an exposure to contribute to certain environmental objectives and so have a high degree of Taxonomy-alignment, but still pose a high prudential transition risk. In addition, reliance on the EU Taxonomy would not provide the whole picture of an institution's transition journey, particularly as non-EU exposures would not fall in scope of the Taxonomy-alignment disclosures. Ultimately, this approach would require institutions to assess Taxonomy alignment even when it is clear that the exposure is not relevant and/or immaterial.

Therefore, we strongly advocate that the EBA revise this approach in the final Guidelines and grant institutions discretion in assessing which sectoral exposures are materially subject to environmental transition and physical risk.

Quantitative and qualitative criteria: While we agree that institutions should consider both qualitative and quantitative elements when assessing the materiality of climate-related financial risks, we believe that the assessment of social and governance risks should focus on qualitative elements only and be done on a best effort basis at this stage.

Financial materiality: The final Guidelines should clarify that their focus is on financial materiality and the management of financial risks only, as their purpose is to support institutions' prudential risk management. The final Guidelines should further clarify the expectation that any financially immaterial risks should not be taken into account.

Overlap with other materiality assessments: We generally agree with the concept of integrating the ESG risk assessment into existing risk identification and management practices, and with integrating the ESG materiality risk assessment into existing materiality assessments, where available. As such, we support the EBA's proposed approach of aligning materiality assessments with materiality assessments already employed in e.g. ICAAPs and ILAAPs. However, see also our comments on the ICAAP in response to Question 10.

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

Access to data and data quality remain key obstacles for meeting transition plan requirements, including prudential transition plans.

The draft Guidelines currently set overly prescriptive processes for gathering and assessing data. For example, para 23 of the draft Guidelines provides a detailed set of minimum data requirements for institutions facing large corporate counterparties under CSRD. Para 22 of the draft Guidelines also states that institutions are expected to implement an approach for engaging with clients and counterparties to capture relevant ESG-related information.

Such a prescriptive approach raises a number of difficulties for institutions, including (but not limited to) difficulties related to data availability and quality and engagement with counterparties. All institutions, regardless of where they are headquartered, will face such issues in the monitoring and

measurement of their ESG risks. We also expect such issues to be particularly acute where an institution has a third-country nexus, for instance when facing a third-country counterparty.

We are, therefore, strongly of the view that the final Guidelines should provide greater flexibility in relation to data gathering and processes. In particular, the final Guidelines should clearly enable institutions to select the data and proxies that best suit their circumstances, just as the EBA proposes to do for methodologies (per section 3, para 10 of the draft Guidelines). The final Guidelines should not prescribe specific environmental, social or governance data that must be gathered from specific counterparties. Furthermore, the final Guidelines should provide flexibility regarding institutions' processes for collecting data. Institutions should be able to select the method that may be most appropriate for them (whether that is reviewing public disclosures or engaging with counterparties), but the particular method should not be prescribed.

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

The final 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. The assessment of risks driven by ESG factors would be complex, as trading book transactions are numerous – including in secondary and private markets, and instruments can be held for very short periods of time. Moreover, banks acting as intermediaries are taking and hedging positions on behalf of clients but not taking risks for periods of time that would expose them to ESG risks. It is unclear which values would make sense considering when assessing ESG risks on trading book transactions: mark-to-market, which is often used to determine a transaction's financial risk, is not relevant when assessing ESG risk factors, as the value of a transaction barely takes into account the exposure of the underlying to ESG risk factors.

If the trading book was to be covered by the final Guidelines, a delayed phase-in period would be necessary to determine the correct methodologies and to obtain data on a scope that is expected to be broader than for the banking book.

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

Flexibility for setting time horizons and milestones: Para 42 of the draft Guidelines states that institutions should develop a robust and sound approach to ESG risk management and mitigation over the short, medium and long term, including a time horizon of at least 10 years. Para 76 further specifies that institutions should establish these time horizons as part of their plans, and also states that institutions should set an intermediate milestone of 2030 to demonstrate how their plans enable them to identify and manage climate-related risks associated with the EU's objectives.

We acknowledge that the EBA is operating within the framework of the Level 1 CRD 6 text, which states institutions' processes for identification, measurement, management and monitoring of risks should consider the *"short, medium and, a long-term horizon of, at least 10 years"* (Art. 87a(2)). Nonetheless, we see various issues with the EBA's approach to setting these time horizons and milestones in the Guidelines. In particular:

- The 10-year time horizon implies enormous challenges given the lack of available data, as well as the uncertainties inherent to the transition.
- The definition of short, medium, and long-time horizons is not aligned with what banks are currently doing under NZBA and CSRD. Introducing further time horizons and milestones under the Guidelines will not be workable for banks.

Institutions should therefore be granted enough flexibility to set their own time horizons and interim milestones under the Guidelines. Institutions should be able to adjust the timing of their plans and procedures to specific circumstances that will progressively arise.

Interaction with ICAAP risk assessment horizons: We assume that the specification of a longer-term time horizon, in this case at least 10 years, is not intended as a multi-year risk-bearing capacity calculation. As we understand it, institutions would include ESG factors in the normative and economic perspective in the ICAAP with the risk assessment horizons that have applied to date.

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?

Similar to our comments on Question 6 regarding data, the final Guidelines should provide more flexibility for institutions regarding the selection of metrics and targets. The final Guidelines should also clarify that banks would only have to set targets and limits for the most relevant metrics.

The draft Guidelines currently set an overly prescriptive list of metrics that institutions should use when setting targets. This again raises various difficulties – for instance, where data for such metrics may not be available, or where such metrics may not be appropriate for the institution's business model. Again, these difficulties may be particularly acute for institutions where a third-country nexus arises. Institutions should have the flexibility to identify metrics and targets that best fit their business model and management of their own ESG transition risks.

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?

We do not think that the EBA should propose any prescriptive format for setting up or disclosing the transition plans. As emphasised in our response to Question 1, it is important to provide institutions with flexibility in relation to the CRD prudential transition plan requirements, including its interaction with other transition plan requirements under CSDDD / CSRD.