Consultation response on EBA's Draft guidelines on ESG scenario analysis

Question 2: Do you have comments on the proposed definition of scenario analysis and various uses as presented in Figure 1?

The presentation of various uses in Figure 1 - as well as the discussion of these uses throughout the draft guidelines – do not emphasize the complementarity between them. More precisely, the two uses targeted by the draft guidelines – to "inform strategy and business model" and to "adapt risk management practices and check capital adequacy" – are not clearly linked.

Indeed, **the proposed approach seems to establish a strong separation between the strategy and business model of the institution and its risk management practices**. Such a strong separation is problematic because it:

- **Ignores the fact that climate alignment (e.g whether an institution's strategy and practices are consistent with the 1.5°C goal and related science-based pathway) is relevant to climate-related risk evaluation and management:**

  As the recently published EBA Guidelines on the management of ESG risks acknowledge, it is clear that alignment is relevant to financial supervision and could play an important role in risk management and mitigation. A misaligned bank exposes itself to heightened transition risks – including litigation risks (see: Frank Elderson, "Come hell or high water": addressing the risks of climate and environment-related litigation for the banking sector", ECB, 2023) - while also contributing to the overall buildup of those risk with an increased probability of "disorderly" transition as well as higher physical risks. A misaligned bank is also likely to be more exposed to sectors and activities that concentrate climate-related risks such as the fossil fuel sector.

  The European Central Bank (ECB) itself underlined in a recent report that EU banks were not aligned with climate goals and that this could be problematic from a risk perspective (see: ECB, Risks from misalignment of banks' financing with the EU climate objectives, 2024). The ECB notes that: "*Alignment assessment is widely recognised as a useful method for quantifying transition risks in a credit portfolio, alongside techniques like scenario analysis, stress testing, exposure analysis and determining financed emissions. While these other methods give an indication of the carbon intensity of a credit portfolio at a certain point in time, alignment assessment provides insight into whether the corporations in a credit portfolio are moving towards low-carbon production. Banks and regulatory and supervisory authorities alike are currently embracing alignment assessment as a tool for evaluating risks and exploring strategies that have a positive impact on the climate*." In an occasional, ECB research team also identified the relevance of the greenwashing risk created by insufficiently substantiated net-zero commitment for supervisors (see: ECB, An examination of net-zero commitments by the world's largest banks, 2024).

In the US, scenario modelling approach from the Department of Insurance of California considers forward-looking plans and alignment with climate scenarios in quantifying the exposure of insurers (see: California Department of Insurance, The hidden cost of delaying climate action for West Coast insurance markets, 2024).

- **Is inconsistent with the EBA Guidelines on the management of ESG risks:**

  The Guidelines on the management of ESG risks notably make clear that institutions should:
  - Use exposure based, portfolio/sector based, alignment based and scenario-based methods to manage these risks.
  - Account for ESG risks when developing and implementing their business and risk strategies.
  - Incorporate material ESG risks into their ICAAP, taking into account the short, medium and long term".
  - Adopt transition plans that include elements such as targets and an implementation strategy.

  While this shows that ESG risk management must cover short, medium and long term, tackle how the institution's business model is resilient and feed into capital adequacy requirements, the strong CST/CRA separation proposed effectively drive institution to focus on short term analysis.

As the elements listed above show, **this separation as the unintended consequence of replicating the "tragedy of horizons" inside risk management practices**. Indeed, only short-term scenario analysis (CST) will directly impact capital adequacy, while the longer-term analysis (CRA) – that may provide elements on how current financial practices expose the institution to risks in the longer-term - will not. This two-track system encourages a risk management process focused on the short-term and – without stringent and forceful enforcement by the EBA – risk making CRA a mere compliance exercise with little impact on institutions.

We suggest the EBA:

- **Ensures results of CRA are linked to action – including climate mitigation and alignment and those listed in the Guidelines on the management of ESG risks – by institutions.**
- **Establishes a clearer link between CRA and capital adequacy processes.**
- **Requires – at least - the main sources of risk identified through CRA (for example exposure to specific activities) to be identified by institutions and subject to specific risk management measures**.

Question 3: Do you have comments on the proposed distinction made between short-term scenario analysis (CST) and longer-term scenario analysis (CRA) as illustrated in Figure 3?

As explained in our answer to question 2, the strong separation between the strategy and business model of the institution and its risk management practices is problematic.

As currently laid out in Figure 3, only CST has direct implications for risk management. However, CRA deals with the institutions' alignment and should also immediately inform risk management. **We suggest the EBA:**

- **Ensures results of CRA are linked to action – including climate mitigation and alignment and those listed in the Guidelines on the management of ESG risks – by institutions.**
- **Establishes a clearer link between CRA and capital adequacy processes.**
- **Requires – at least - the main sources of risk identified through CRA (for example exposure to specific activities) to be identified by institutions and subject to specific risk management measures**.

Additionally, we note CST relies on less risky assumptions than CRA. This is understandable but also worrying. Indeed, the EBA rightfully underlines in the draft "*Three aspects specifically require further examination and a change in perspective: the extended time horizon, the new risk transmission channels not fed by existing data and finally, the fundamental uncertainty surrounding the shifts in economies around the world."* Yet, **the assumptions used for CST do not account for these specificities, and especially potential sudden shifts and uncertainty. CST should notably explicitly include assumptions related to climate tipping points and tail risks**.

Question 5: Do you have comments on the Climate Scenario Analysis framework as illustrated in Figure 4?

We would like to reiterate the points made in our response to questions 2 and 3.

We note the EBA acknowledges the challenges related to data quality and requires progressive improvement. Yet, the EBA fails to acknowledge the radical uncertainty tied to climate related risks, and therefore the fact that data will always remain partial as well as the extent of the challenges in scenario analysis (see: Finance Watch, *Bridging the gaps in climate scenarios: Prudential approaches to compensate for underestimated climate costs*, 2025). **The specificities of climate related risks warrant a precautionary approach** that considers acting now to mitigate climate change as a needed risk management tool (see: Hugues Chenet and al, "Finance, climate-change and radical uncertainty: Towards a precautionary approach to financial policy", *Ecological Economics*, 2021 / Hugues Chenet and al, "Developing a precautionary approach to financial policy – from climate to biodiversity", *INSPIRE*, 2022).

The EBA should therefore:

- **Make clear the limitations of scenario analysis, and the need to supplement it with policies and direct action.**
- **Ensure results of scenario analysis are linked to action – including climate mitigation and alignment – by institutions.**

Question 8: Do you agree that the proposed proportionality approach is commensurate with both the maturity of the topic and the size, nature and complexity of the institution's activities?

Regarding proportionality related to the maturity of the topic and data availability, we highlight that this should be done with extreme caution as there are inherent challenges to climate-related data. As underlined in question 5, climate change is characterized by a radical uncertainty that calls for a precautionary approach. To manage potential risks, institutions should consider how their current practices affect climate change and contribute to climate mitigation. In fact, as the NGFS also pointed out, ample data is already available on climate change or specific high impact activities (e.g fossil fuels) and should be immediately leveraged.

More broadly, **proportionality should also account for the potential concentration of activities of banks in specific sectors or areas**. This is especially the case for SNCI that are more susceptible to being overexposed to specific regions or activities.

Question 9: Do you agree with the proposed references to organisations in paragraph 28? Would you suggest alternative or complementary references?

Other organizations such as the IEA and IPCC could be included.

Question 10: Do you have additional comments on section 5.1 Setting climate scenarios?

To avoid further underestimation of potential risk, macroeconomic downturns should be more clearly embedded in the analysis.

Question 13: Do you have comments on the Climate Resilience Analysis (CRA) tool and its use to challenge an institution's business model resilience?

As underlined in our responses to questions 2 and 3, the EBA should require the CRA to be linked to (i) risk management practices, including those listed in the Guidelines on the management of ESG risks, and (ii) capital adequacy.

We note that paragraph 82 indicates that:
"*Among possible follow-up actions, institutions should consider, in addition to the combination of risk management and mitigation tools provided for in paragraph 46 in the Guidelines on the management of ESG risks, and among other things, the following:*
(i) provide for a gradual increase in capital over time to strengthen the institution's resilience in the face of changing environmental conditions;
(ii) regularly update risk inventory with any newly identified significant climate risk. This involves identifying new risk factors, their transmission channels and their potential impact on the resilience of the business model;
(iii) perform further analysis on a segment of the portfolio for which a vulnerability has been identified, in order to refine the course of action."

However, the wording used in this paragraph is much too weak and merely suggest institutions connect CRA to capital and risk management and mitigation tools. We therefore emphasis the need for the EBA to strengthen this paragraph and other relevant provisions to:

- **Ensures results of CRA are linked to action – including climate mitigation and alignment and those listed in the Guidelines on the management of ESG risks – by institutions.** At the very least, the main sources of risk identified through CRA should be subject to specific risk management measures.
- **Establishes a clearer link between CRA and capital adequacy processes.**

Furthermore, **we note the draft guidelines rightfully point out the need for institutions to ensure consistency between their projections and their targets (see notably Paragraph 75). However, here the EBA puts the focus solely on financed GHG emissions. The EBA should amend this** because:

- Financed emissions are an unreliable metric that is difficult to link to changes in real world emissions (see: Reclaim Finance, *Targeting Net Zero: The need to redesign bank decarbonization targets*, 2024). Other types of emission targets – especially sectoral targets in physical intensity – should be favored and used as references.
- Beyond GHG emission targets, other elements are essential to understand alignment and potential risk exposure. This especially includes practices related to fossil fuels as:
    - Despite major limitations in scenario and stress testing (see: Sandy Trust and all, The Emperor's New Climate Scenarios, 2023 / Finance Watch, Finance in a hot house world, 2023), preliminary exercises all identified fossil fuel activities as higher risk. This is notably the case of the stress test conducted by the ECB, the ACPR and other European regulators and supervisors (see: ESRB, Towards macroprudential frameworks for managing climate risk, 2023 / ECB, The Road to Paris: stress testing the transition towards a net-zero economy, 2023 / ACPR, Les principaux résultats de l'exercice pilot 2020, 2021 / Luis de Guindos, "Shining a light on climate risks: the ECB's economy-wide climate stress test", ECB, 2021). Recent scenario analysis conducted by the Department of Insurance of California further underlined that the plans of oil and gas companies in US West Coast insurers' portfolios are not aligned with policies implemented in 2021 implies "exposure to transition risk even in the absence of any additional collective climate action", and that coal and oil and gas have the highest probability of default in delayed/disorderly transition scenarios (see: California Department of Insurance, Executive Summary The hidden cost of delaying climate action for West Coast insurance market, 2024).
    - Beyond the results of stress tests and quantitative analysis, fossil fuel assets are notably exposed to a "stranding risk" (see: Carbon Tracker, Oil & Gas: 2023 Assessments for Climate Action 100+, 2023 / Harry Benham, "Energy is a very long game: yet fossil fuel companies are taking a lot of short-term risks", Carbon Tracker, 2024 / Institut Rousseau and al, Actifs fossiles, les nouveaux subprimes ?, 2021). This is especially the case for assets tied to new production projects, as these assets are not needed in a scenario where actions are carried out to limit global warming to 1.5°C and will take decades to recover their investment cost. New fossil fuel production assets have a high chance to be closed before amortization or require the faster closure of pre-existing assets, and thus are a major source of risks as identified by the International Energy Agency (IEA) (see: IEA, World Energy Outlook 2023, 2023 / IEA, The Oil and Gas Industry in Net Zero Transitions, 2023 / IEA, NZE 2023 Update, 2023). This also means that bank's continued support to fossil fuel developers (see: Rainforest Action Network and al, Banking On Climate Chaos 2023, 2023 / Reclaim Finance, Oil and Gas Policy Tracker, online tool / Reclaim Finance, Coal Policy Tracker, online tool) breaches their net-zero and climate commitments, thus bringing additional transition risks (see: ECB, An examination of net-zero commitments by the world's largest banks, 2024).
    - If oil and gas production is predominantly localized outside of EU and OECD countries, this does not mean that investors and banks are less exposed to the asset standing risk (see: Gregor Semieniuk and al, "Stranded fossil-fuel assets translate to major losses for investors in advanced economies", Nature Climate Change, 2022). However, asset stranding risk is not considered by EU banks, despite its effect being potentially amplified by the indirect exposure to fossil fuels and second-round effects in financial markets in case of sudden loss of value (see: Winta Beyene and al, Financial institutions' exposures to fossil fuel assets: An assessment of financial stability concerns in the short term and in the long run, and possible solutions, Economic Governance Support Unit of the European Parliament, 2022). This is especially worrying since fossil fuel exposures already constitute a high share or even

exceed the Common Equity Tier 1 (CET1) of these banks (see: ECB, Risks from misalignment of banks' financing with the EU climate objectives, 2024 / Institut Rousseau and al, Actifs fossiles, les nouveaux subprimes ?, 2021 / Bank of England, Financial Stability Report, 2019).

- At a macro-prudential level, the ECB and European Systemic Risk Board (ESRB) have long used fossil fuel exposures and related criteria in their analysis (see: ESRB and ECB, The macroprudential challenge of climate change, 2022 / ESRB, Towards macroprudential frameworks for managing climate risk, 2023). The EIOPA is now considering introducing additional capital requirements on fossil fuels (see: EIOPA, Consultation on the Prudential Treatment of Sustainability Risks, 2023), a proposal that has been championed by civil society organizations focusing on financial stability (see: Finance Watch, A safer transition for fossil banking: Quantifying capital needed to reflect transition risk, 2022). Additionally, establishing restrictions on financial services to the fossil fuel industry is an element of the good practices identified by the ECB on climate and environmental risk management (see: ECB, Good practices for climate and environmental risk management, 2022), and that excessive support to this industry is one of the factor of misalignment of European banks with climate goals identified by the central bank (see: ECB, Risks from misalignment of banks' financing with the EU climate objectives, 2024).