3. Februar 2021

VAB Feedback on the EBA's Discussion Paper on management and supervision of ESG risks for credit institutions and investment firms

Q 15. Please provide your views on the extent to which smaller institutions can be vulnerable to ESG risks and on the criteria that should be used to design and implement a proportionate ESG risks management approach.

The Association of Foreign Banks in Germany represents about 200 institutions, among which are credit institutions as well as investment firms. All of them are subsidiaries or branches of parent undertakings or head offices that are located outside Germany, i.e. in the EEA or in third countries. For the purposes of this question, we focus on subsidiaries, for they are most likely in the scope of ESG risk management provisions.

It should be borne in mind that, as a matter of fact, the size of a subsidiary is not directly correlated to the size of the parent undertaking. We observe a lot of subsidiaries that would generally qualify as small institutions on a solo level, even if the group or parent is of significant size at its home country.

Furthermore, we note that EBA correctly characterizes ESG risk as being a kind of reputational risk on the one hand, and a category of (measurable) credit or market risk on the other hand.

Against this background, we recommend to the EBA taking into account the following:

1. As regards **ESG risk in the form of reputational risk**, parent undertakings / groups of undertakings and subsidiaries cannot be regarded independently from another. Reputational issues on the group level will always spill over to the subsidiary level and vice versa.

2. As regards **ESG risk in the form of credit or market risk**, risk management is always better performed at the group level on the basis of consolidated data and personal and financial resources. That is because the data on this sub-category of risk and more specifically the quantification of it can only be obtained in large sample groups (the larger the better). The reason for this is that only very few cases of default can be clearly allocated to ESG risk manifestation to date. Furthermore, ESG risks take very long time spans to materialize, especially climate risk. So as a consequence, the limited data on a subsidiary's solo level should be expected to be misleading. In addition, group-wide know-how in the field of ESG risk should be concentrated to be optimally elaborated.

3. Risk management should always be in line with **sound management principles**. One of these principles is that it should not eat up more resources than the management of risk is able to protect and preserve in the long run. The costs of ESG risk management must not exceed the financial benefits that could reasonably be expected on the profit and loss accounts of a given institution. Otherwise, the risk management would endanger the profitability and the survival of the institution itself even more than the lack of ESG risk management would. If disproportionate ESG risk management was applied to the entirety of small institutions, the financial system would be put under stress by well-meaning regulation. In other words, the "too small to comply"-effect is systemically detrimental.

Our conclusions from this can be summarized in the following proposals:

- ESG risk management should basically be **conducted on a consolidated level** for the parent as well as for all subsidiaries.

- In the EU, this is only possible by creating **perfectly harmonised rules**, to the extent local supervisors cannot create gold-plating or regulatory loopholes. As an alternative, we strongly recommend to consider if, by way of an extension of the principle of mutual recognition of supervision, for the purposes of ESG risk management the supervision should be **entrusted to the supervisory authority which is competent on the consolidated level**, encompassing also all EEA subsidiaries (even if located in another Member State).

- As regards small institutions which do not form part of a bigger EU group, **one-time and ongoing costs** of ESG risk management should be carefully weighed against **measurable financial benefits** from better risk avoidance that can reasonably be expected to accrue.

- Our main proposal in this regard would be to start off with a more **"phasing-in" approach for small institutions** which could be reassessed in periodic intervals, e.g. every 5 years. In doing this, the legislator and supervisors would be taking into account that to date, measurable negative risk-effects of climate risk on small banks tend to be infinitesimal or non-quantifiable due to the lack of data, whereas we are perfectly aware that this kind of risk is unfortunately to be expected to increase continuously in the decades to come.

- We would also like to ask the EBA to consider that some of the main business areas of foreign banks in Germany, for example short-term trade finance, are not at all affected by ESG risks manifested through credit risks. This should be addressed with appropriate regulations that **allow national supervisors to issue waivers** according to fixed principles and criteria.