Verband der Auslandsbanken in Deutschland e.V.
Association of Foreign Banks in Germany

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VAB-Statement on
EBA Discussion Paper on the role of environmental risks in the prudential framework

Q1: In your view, how could exposures associated with social objectives and/or subject to social impacts, which are outside the scope of this DP, be considered in the prudential framework? Please provide available evidence and methodologies which could inform further assessment in that regard.

We agree with the opinion of EBA that social objectives and impacts could have interlinkages with environmental risks. However, from our point of view, no further risk category in terms of social risks should be included in the risk classification matrix. Social aspects and related developments and risks (as described in margin number 9 of the Discussion Paper (**DP**)) are already considered by credit institutions in their risk assessment and are also part of the annual report, especially in the risk report of a company. For this reason, we do not consider that new methodologies should be developed.

Moreover, if social risk was defined as problematic behavior of counterparties as regards human right or labour laws, this is to become a compliance issue rather than a risk management issue, or in other words, institutions will be forbidden to engage in risky behavior according to the proposed Corporate Sustainability Due Diligence Directive. This means, such risks will not be relevant for risk management anymore because they are to be avoided in total.

Also, we presume that the whole concept of creditworthiness is a description of social risk, because over longer periods of time, the stability of a natural person's financial situation is basically standing on the same factual grounds as the social situation. Therefore, it is unnecessary to, e.g., introduce the risk of social thrift connected with recessions as an additional aspect of risk management, as this is already an integral part of the economic outcome of recessions.

Redefining or adding particular aspects of social situations as a borrower's bonus or malus could easily backfire on institutions as this would be a form of personal discrimination against subgroups of the population, much like a "social bonus"-system. E.g., if persons were "judged" with a view to life circumstances prone to the effects of climate change, e.g. the nature of their professional activity (e.g. agriculture), or place of living (on the coast or near a river), that would be really highly problematic and discriminatory, and exacerbate social tension.

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Association of international banks, investment firms and asset managers

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Chapter 4 – Principles, premises and challenges

Q2: Do you agree with the EBA's assessment that liquidity and leverage ratios will not be significantly affected by environmental risks? If not, how should these parts of the framework be included in the analysis?

Yes, we agree with the explanation in margin number 27 of the DP.

Q3: In your view, are environmental risks likely to be predominantly about reallocation of risk between sectors, or does it imply an increase in overall risk to the system as a whole? What are the implications for optimum levels of bank capital?

Climate change and environmental pollution are topics that have increasingly come into focus, especially in the last decade. In our view, a rethink has taken place in this regard in the last ten years in particular. Environmental risks are not only discussed, but have already found their way into risk consideration and assessment. This is shown, for example, by a study conducted by the British Prudential Regulatory Authority (PRA). This study of the British banking market, for example, found that while 30 percent of the institutions surveyed see climate risks primarily as a matter of corporate social responsibility (CSR), 60 percent already view climate risks as financial risks in a three- to five-year horizon and ten percent even apply a long-term strategy.[1] Although the British banking market cannot be transferred one-to-one to the European financial sector, the results of this study show that climate risks are being taken into account in the banking sector. In our opinion, this can also be observed in the European financial market. For this reason, climate risks are not a new risk category, but rather a focusing or highlighting of a type of risk that is already part of general risk consideration and assessment. Thus, in our view, environmental risks do not so much lead to a reallocation of risk between sectors or to an increase in the overall risk to the system as a whole. Rather, there is a more comprehensive consideration of this type of risk, which undoubtedly has an impact on regional and global developments in society, industry and the financial sector.

As a consequence, we largely agree with EBA's analysis in Chapters 4.1. and 4.2. of the DP. We agree that specificities in the risks ('risk differential') of some exposures should be the key element to consider for adjusting the prudential treatment.

However, the CRR should not be geared at incentivising institutions to redirect capital and using prudential regulation to increase demand for green assets or penalise environmentally harmful assets, for the analysis of potentially harmful unintended consequences is correct. From our point of view, as we represent internationally active banks, investment firms and asset managers, we are particularly sensitive to any distortions of the international level playing field. We also agree that the primary responsibility and most effective tools for dealing with environmental-risk-related externalities lie within the remit of political authorities.

About Q3 more specifically: Basically, environmental risks should not be considered as risk drivers that translate through a range of channels into the traditional categories of financial risks. As far as we know, however, the degree of how such risk drivers materialise in a quantifiable manner still remains to be shown. The assessment should be evidence-based, so that the materialization of risk drivers in quantifiable risk can be clearly demonstrated. Until this is the case,

[1] See PRA, "Transition in thinking: The impact of climate change on the UK banking sector", page 11, 2018, https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/report/transition-in-thinking-the-impact-of-climate-change-on-the-uk-banking-sector.pdf.

unfortunately, the answer to Q3 remains in the realm of speculation. Mostly through the lack of data we lack evidence-based criteria that could be a means of measuring ESG risk drivers and the extent to which they show up differently in sectors and/or in an increase in overall risk to the system.

So, the honest answer to Question 3 would be simple, albeit unsatisfactory: At the moment, we don't know.

Q4: Should the 'double materiality' concept be incorporated within the prudential framework? If so, how could it be addressed?

We agree that 'double materiality' is an issue. But we would suggest that the Pillar 1 view on banks should exclusively focus on the risk-based perspective, so that environmental risks for institutions can be defined as the negative materialisation of environmental factors through their counterparties or invested assets (financial materiality).

As regards the inside-out perspective (environmental materiality), the evaluation of the economic and financial activities of counterparties and invested assets is highly problematic because it is not possible without several basic paradigms and assumptions on the causal chains in play, i.e.

- an institution (and/or its supervisor) is able to recognise, with reasonable certainty, which economic or financial activities of counterparties have or will have a negative impact on environmental factors, and
- this negatively affects the value of these counterparties' activities.

Both of these premises seem quite logical when deduced from prevailing paradigms, but they are in fact largely dependent on future political factors, because in the end, the legislators and governments decide, based on political majorities, which activities are deemed negative for environmental factors and which of these activities are addressed by laws and therefore negatively impacted. E.g., weaponry manufacturers and related suppliers seemed to be in environmentally harmful businesses just a few months ago. Now it suddenly became clear that their activity is one of the basic foundations of a society that democratically agrees ESG policies in the first place.

Therefore, lacking the possibility of reliable long-term predictability of the causal chains between environmental effects and materiality, negative effects on activities of counterparties and then an institution's risk profile, the so-called environmental materiality aspect of ESG factors should not be incorporated in the Pillar 1 framework.

Instead, we think that environmental materiality as defined in the DP is an issue that should mainly be dealt with in institutions' business strategies (see our answer to Q8).

Q5: How can availability of meaningful and comparable data be improved? What specific actions are you planning or would you suggest to achieve this improvement?

First of all, we fully agree with the descriptions of the challenges in the measurement of ESG risks which are described in margin number 33 of the DP. Against this background, we are of the opinion that the most essential issue in this case is the lack of a common, standardized and complete classification system. In our daily business, we observe that almost every credit

institution that is subject to the European ESG regulations uses or has to use its own definitions if no uniform understanding can be derived from the international or European regulations. Therefore, it may well be the case that ESG-related aspects are evaluated and assessed very restrictively or extensively. As a consequence, there is not only a multitude of approaches and attempts at definitions, but there is also the danger that risks are either over- or under-assessed. In our view, therefore, uniform definitions, metrics and expectations regarding ESG-related aspects should be formulated first before credit institutions are required to assess risks that are either not quantifiable or definable.

Q6: Do you agree with the risk-based approach adopted by the EBA for assessing the prudential treatment of exposures associated with environmental objectives / subject to environmental impacts? Please provide a rationale for your view.

Yes, we agree.

We support the view that environmental factors that affect institutions in the short to medium term should be (and, in fact, are already) reflected in the CRR framework, while for the long-term impact institutions should rather be expected to take appropriate mitigating actions in their strategies (if necessary, on an individual assessment's basis). For long-term time horizons, the ability of institutions to take suitable management actions tends to be underestimated. Institutions are able to adapt in a short time frame even to massively changing environments, as demonstrated through a history of extreme business cycles and unintended central bank policy consequences in the last decades. Climate risk factors don't reach any comparable magnitude at present and in the foreseeable future.

Q7: What is your view on the appropriate time horizon (s) to be reflected in the Pillar 1 own funds requirements?

It should be short and medium term, because long term developments can be addressed appropriately by management actions if necessary.

Q8: Do you have concrete suggestions on how the forward-looking nature of environmental risks could be reflected across the risk categories in the Pillar 1 framework?

We agree with the statement in margin number 42 of the DP that environmental risks have to be characterised by the uncertainty on their exact manifestation and magnitude. Against this background, we are of the opinion that only the use of historical climate data and records, their evaluation as well as scientific studies and surveys on the influence of climate changes can be suitable to serve as a basis for the preparation of short- and medium-term climate forecasts on possible but expectable climate changes. In our opinion, these could at least be used to identify trends (developments). However, such historical climate data and records, their evaluation as well as scientific studies and surveys on the influence of climate changes should be carried out by public bodies or scientifically recognized institutions to ensure the quality and validity of the corresponding data and information. Only on this basis could banks then perform a well-founded and plausible assessment of climate risks at all.

Chapter 5 – Credit risk

Q9: Have you performed any further studies or are you already using any specific ESG dimensions to differentiate within credit risk? If so, would you be willing to share your results?

NA

Q10: What are the main challenges that credit rating agencies face in incorporating environmental considerations into credit risk assessments? Do you make use of external ratings when performing an assessment of environmental risks?

From our association's perspective, the following aspects represent the greatest challenges for credit rating agencies:

- Lack of reliable data sources and ESG-related definitions. Therefore, we fully agree with the description in margin number 97 of the DP)
- No uniform and partly non-transparent methodology for ESG ratings: Each credit rating agency uses its own methodology to evaluate a company according to ESG aspects. However, this often causes a different classification of one and the same company. This entails the risk that, in principle, no clear investment decisions can be made, i.e. the same investment decision would be classified as ESG-compliant by one credit rating agency when using ESG data, while another provider would rate it as no longer ESG-compliant.[2]

Q11: Do you see any challenge in broadening due diligence requirements to explicitly integrate environmental risks?

A non-risk based approach, or any approach not incorporating the principle of proportionality, would carry the risk of increasing due diligence costs much more than benefits could be generated on the risk management side. This applies especially for small and medium-sized institutions. ESG due diligence is a resource-consuming task, and if costs exceed benefits on an institution's level, that institution will be in a greater risk of deteriorating financials than if ESG due diligence was not performed at all. This is also due to the comparatively non-significant ESG risk, which by far does not reach the risk from other external stress events. As a consequence, the ESG due diligence costs could be outweighed by benefits only where an institution has considerable scaling effects with regard to assets concerned.

Q12: Do you see any specific aspects of the CRM framework that may warrant a revision to further account for environmental risks?

NA

Q13: Does the CRR3 proposal's clarification on energy efficiency improvements bring enough risk sensitiveness to the framework for exposures secured by immovable properties? Should further granularity of risk weights be introduced, considering energy-efficient mortgages? Please substantiate your view.

[2] See *Berg, Kölbel und Rigobon*, "Aggregate Confusion: The Divergence of ESG Ratings", 2019.

From our point of view, the CRR3 proposal's clarification on energy efficiency improvements bring enough risk sensitiveness to the framework for exposures secured by immovable properties. No further granularity of risk weights should be introduced.

Energy efficiency increases building costs, so EBA is right by stating that it is yet unclear, whether energy efficiency investments of homebuyers increase or decrease the credit risk or PD. So we see the CRR3 proposal as a political intervention, which not necessarily justified by data.

Q14: Do you consider that high-quality project finance and high-quality object finance exposures introduced in the CRR3 proposal should potentially consider environmental criteria? If so, please provide the rationale for this and potential implementation issues.

NA

Q15: Do you consider that further risk differentiation in the corporate, retail and/or other exposure classes would be justified? Which criteria could be used for that purpose? In particular, would you support risk differentiation based on forward-looking analytical tools?

Such differentiation should only be introduced based on demonstrable data which shows the necessity for it. Currently, however, we are not aware of such data and would deem such differentiation as politically motivated to discriminate against certain types of borrowers.

Q16: Do you have any other proposals on integrating environmental risks within the SA framework?

At the present stage, we would suggest not to integrate environmental risk in the SA framework, because of the lack of reliable data such measure could be based upon.

Q17: What are your views on the need for revisions to the IRB framework or additional guidance to better capture environmental risks? Which part of the IRB framework is, in your view, the most appropriate to reflect environmental risk drivers?

Currently, we see no need to revise the IRB framework. In this context, we concur with the comments in margin number 131 of the DP which states that the most environmental risks have likely not fully materialised yet, or not in the expected frequency or with the expected impact on credit risk. Therefore, it is difficult at this point in time to adapt the IRB framework or to add further requirements. This is particularly difficult because the data basis required to meet new requirements is not yet sufficiently available.

Q18: Have you incorporated the environmental risks or broader ESG risk factors in your IRB models? If so, can you share your insight on the risk drivers and modelling techniques that you are using?

NA

Q19: Do you have any other proposals on integrating environmental risks within the IRB framework?

NA

Q20: What are your views on potential strengthening of the environmental criterion for the infrastructure supporting factor? How could this criterion be strengthened?

NA

Q21: What would in your view be the most appropriate from a prudential perspective: aiming at integrating environmental risks into existing Pillar 1 instruments, or a dedicated adjustment factor for one, several or across exposure classes? Please elaborate.

We agree with the statement in margin number 144, according to which “the most consistent way forward from a prudential risk-based perspective leans towards clarifying the extent to which environmental risks are already captured and assessing ways to further integrate these risk drivers into existing Pillar 1 instruments”.

We clearly disagree with the proposals to introduce dedicated non-risk-based adjustment factor(s) which favour some exposure classes over others, as long as reliable data is non-existent. This would be an element of planned economy that is not based on factual knowledge of risk factors, but on political discretion. It has all the unintended consequences mentioned in the CP.

Q22: If you support the introduction of adjustment factors to tackle environmental risks, in your view how can double counting be avoided and how can it be ensured that those adjustment factors remain risk-based over time?

NA

Chapter 6 – Market risk

Q23: What are your views on possible approaches to incorporating environmental risks into the FRTB Standardised Approach? In particular, what are your views with respect to the various options presented: increase of the risk-weight, inclusion of an ESG component in the identification of the appropriate bucket, a new risk factor, and usage of the RRAO framework?

NA

Q24: For the Internal Model Approach, do you think that environmental risks could be better captured outside of the model or within it? What would be the challenges of modelling environmental risks directly in the model as compared to modelling it outside of the internal model? Please describe modelling techniques that you think could be used to model ESG risk either within or outside of the model.

NA

Q25: Do you have any other proposals on integrating environmental risks within the market risk framework?

NA

Chapter 7 – Operational risk

Q26: What additional information would need to be collected in order to understand how environmental risks impact banks' operational risk? What are the practical challenges to identifying environmental risk losses on top of the existing loss event type classification?

NA

Q27: What is your view on potential integration of a forward-looking perspective into the operational risk framework to account for the increasing severity and frequency of physical environmental events? What are the theoretical and practical challenges of introducing such a perspective in the Standardised Approach?

We consider that the integration of a forward-looking perspective into the operational risk framework to account for the increasing severity and frequency of physical environmental events is necessary in principle in order to be able to make a comprehensive and correct assessment of environmental risks as part of operational risks.

However, we have doubts about this at the present time, as the lack of data means that it is virtually impossible to make a forward-looking assessment of environmental risks as part of operational risks. For this reason, we see the need to first determine the criteria for collecting the necessary data and to coordinate these with the market participants. Only then, it will be clear which data should and could be used for a forward-looking risk assessment. However, before these data can be evaluated as meaningful, a certain time period of at least 3 until 5 years is necessary. Therefore, in our opinion, no concrete requirements should be addressed to market participants in this regard at the present time.

Q28: Do you agree that the impact of environmental risk factors on strategic and reputational risk should remain under the scope of the Pillar 2 framework?

We fully agree that the impact of environmental risk factors on strategic and reputational risk should remain under the scope of the Pillar 2 framework.

Q29: Do you have any other proposals on integrating environmental risks within the operational risk framework? Chapter 8 – Concentration risk

NA

Q30: What, in your view, are the best ways to address concentration risks stemming from environmental risk drivers?

NA

Q31: What is your view on the potential new concentration limit? Do you identify other considerations related to such a limit? How should such a limit be designed to avoid the risk of disincentivising the transition?

We are very critical about the proposal for a new concentration limit. This is mainly for the reasons given in margin numbers 208 to 210 and 212 of the DP. Such a new concentration limit entails the risk of boycotting or sanctioning of certain companies, sectors or geographical regions. It restricts the free movements of services in an unreasonable manner and limits the freedom of competition. In our opinion, this cannot be in the interests of the supervision. For this reason, the establishment of a new concentration limit should be abstained from. Also, the "risk of disincentivizing the transition" is not a risk from the institutions' financial perspective, and should not be in the scope of prudential supervision either.

Chapter 9 – Investment firms

Q32: With reference to the three risk categories the IFR is based on (Risk-to-Client, Risk-to-Market and Risk-to-Firm), which of these could be related to environmental risks, and to what extent?

NA

Q33: Should any of the existing K-factors incorporate explicitly risks related to environmental factors?

NA

Q34: What elements should be considered concerning the risk from environmental factors for commodity and emission allowance dealers? Are there any other specific business models for which incorporation of environmental factors into the Pillar 1 requirements of the IFR would be particularly important?

NA

Q35: Do you have any other suggestions as to how the prudential framework for investment firms could be adjusted to account for environmental risk factors?

NA