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Deloitte Banking Alert

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EBA: Pillar 1 enhancements to capture environmental and social risks

The European Banking Authority (EBA) published on the 12th of October a Report on the role of environmental and social risks in the prudential framework of credit institutions and investment firms. Taking a risk-based approach, the Report assesses how the current prudential framework captures environmental and social risks.

Environmental and social risks are changing the risk profile for the banking sector and are expected to become more prominent over time. They affect traditional categories of financial risks, such as credit, market and operational risks. Consequently, environmental and social factors may affect both the risks faced by individual institutions and the financial stability of the entire financial system.

EBA short-term recommendations regarding the implementation of CRR3/CRD6

Taking into consideration the above-mentioned background, the EBA is proposing to:

- Include environmental risks as part of stress testing programmes under both the internal ratings-based (IRB) and the internal model approaches (IMA) under the Fundamental Review of the Trading Book (FRTB).
- Encourage inclusion of environmental and social factors as part of external credit assessments by Credit Rating Agencies.
- Encourage the inclusion of environmental and social factors as part of due diligence requirements and valuation of immovable property collateral.
- Require institutions to identify whether environmental and social factors constitute triggers of operational risk losses.
- Progressively develop environment-related concentration risk metrics as part of supervisory reporting.

Taking a medium-to-longer term perspective, the Report also presents possible revisions of the Pillar 1 framework reflecting the growing importance of environmental and social risks. These include:

- The possible use of scenario analysis to enhance the forward-looking elements of the prudential framework.
- The role that transition-plans could play in the future as part of the development of further risk-based enhancements to the Pillar 1 framework.
- Reassessing the appropriateness of revising the IRB supervisory formula and the corresponding standardised approach (SA) for credit risk to better reflect environmental risk elements.

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- The introduction of environment-related concentration risk metrics under the Pillar 1 framework.

Alongside other policy initiatives outside the prudential framework, the EBA will continue to strengthen the integration of environmental and social risks across all pillars of the regulatory framework.

Conclusions

As the sustainable finance framework develops, future phases of work on prudential treatments may also need to consider new policy tools and options, as well as broader considerations around their design. This further underlines the importance of monitoring future developments relevant to environmental risk assessment and allocation associated with the transition to a sustainable economy, when developing potential further risk-based enhancements to the Pillar 1 framework. In particular, it will be important to ensure that impending and future adjustments result in appropriate risk differentiation between firms that are adapting successfully to this transition, and firms that are exposed to greater risk as part of this transition.

The EBA will continue strengthening the integration of E&S risks across all pillars of the regulatory framework, hence contributing – alongside broader and more critical policy initiatives outside the prudential framework – to supporting the transition towards a more sustainable economy, while ensuring that the banking sector remains resilient.

For further questions regarding the aspects mentioned in this alert, please don't hesitate to contact us:

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