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Deloitte Banking Alert

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The EBA's latest Consultation Paper: Incorporating EGS risks into the governance, risk management and supervision of institutions

The European Banking Authority (EBA) has recently published a Discussion Paper regarding Environmental, Social and Governance (ESG) risks management and supervision, whose aim is to collect feedback that will be further taken into account while preparing the final report on this topic.

Thus, the Discussion Paper proposes how the ESG factors and ESG risks should be included in the regulatory and supervisory framework for credit institutions and investment firms.

The consultation process is scheduled to run until February 3, 2021 and the report is expected to be delivered in June 2021.

Key aspects

To begin with, the purpose of the discussion paper is to:

- Firstly, present the understanding of the EBA on the relevance of ESG risks for a sound functioning of the financial sector;
- And secondly, collect feedback and comments from stakeholders that will be used in the final report.

The financial materiality of ESG risks will have to be carefully assessed both by institutions and supervisors. Taking into account the fact that not all the financing activities are likely to be equally affected by ESG risks, institutions and supervisors should be able to distinguish and form a view on the relevance of ESG risks, following a proportionate and risk-based approach that considers the severity and likelihood of the materialisation of ESG risks.

Within the discussion paper, ESG factors and ESG risks are identified and explained, highlighting the risks rising from environmental factors and mainly climate change, reflecting the ongoing activities and progress that has been achieved over the recent years by institutions and supervisors.

Moreover, social and governance factors are also included within the analysis, according to the EBA's legal mandates. The paper discusses aspects in regards to why and how these factors can be sources of risk for the financial institutions.

The EBA admits the fact that the qualitative and quantitative indicators and also the metrics and methods that are currently available to institutions for assessing the risks, may be more advanced for environmental risks compared to social and governance risks.

Thus, the management of ESG risks by institutions and the incorporation of ESG risks in the supervision process may be, initially, more notable in regards to environmental risks. Despite this, the progress in this policy field (including the development of the EU Taxonomy Regulation) will progressively allow institutions and supervisors to assess social and governance factors and then integrate them into the management and supervision process of ESG risks.

Although there are numerous methods for assessing the ESG risks on the market at the moment, all of these methods ultimately have the same objective: assessing the alignment of the institutions' portfolio with the global goals in terms of sustainability and offering insights into the risk caused by exposures to certain sectors.

These approaches have been collected and divided by the EBA into three different types:

1. Portfolio alignment method;
2. Risk framework method;
3. Exposure method.

Each of the approaches is different in regards to what it measures and how the overall outcome can be used by the institutions. The decision on which approach to choose, depends on the size, complexity and business model of the institution.

The EBA sees the need for intensifying the incorporation process of ESG risks into the institutions' business strategies, processes and proportionately incorporate ESG risks within their internal governance arrangements.

The EBA also sees the need to progressively develop approaches and methodologies to a climate risk stress test, while taking into account the methodological and data constraints.

The objective of the climate risk stress test would be to inform regarding the resilience of institutions' business model and investment strategies. In order for the ESG risks to be reflected in the supervisory evaluation, the EBA sees the need to gradually incorporate the ESG factors into the analysis of the business model (mainly with regards to the analysis of the business environment, the actual business model, the strategy's analysis as well as the assessment of the viability and sustainability of the business model).

However, the actual assessment under the Supervisory Review and Evaluation Process (SREP) of credit institutions might not sufficiently permit supervisors to understand the longer-term impact of ESG risks, its magnitude and breadth, on future financial positions and related long-term vulnerabilities. In this regard, the EBA identifies the need to implement a new area of analysis in the supervisory assessment, which should evaluate if credit institutions sufficiently test the long-term resilience of the business model against the time horizon of the relevant public policies or broader transition trends.

The discussion paper is linked with the work performed by other stakeholders, central banks, the supervisory community and other relevant authorities. Also, particular attention is paid to the existing EU initiatives of the EU commission, notably the EU taxonomy.

The feedback collected will be taken into account for the final report on management and supervision of ESG risks for credit institutions and investment firms that will be issued by the EBA.

The feedback will also be taken into consideration for the EBA's ongoing work related to the fulfilment of its mandates to develop a technical standard implementing the ESG risks Pillar 3 disclosure requirements included in Part Eight of CRR2 and to evaluate if a dedicated prudential treatment of exposures related to assets or activities associated substantially with environmental and/or social objectives would be justified as a component of Pillar 1 capital requirements, as explained in the EBA's Action Plan on Sustainable Finance.

The EBA mandates will help defining and developing the framework in the field of sustainable finance that should provide insights for institutions and policymakers, supervisors as well as to wider market participants.

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Sources:

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