Deloitte Consultanta SRL
The Mark Tower, 84-98 Grivitei Road,
10th Floor
Bucharest, District 1, Romania, 010735
Tel: +40 21 222 16 61
Fax: +40 21 222 16 60
www.deloitte.ro

Deloitte Banking Alert

February 2024

Charting the Future: EBA's Consultation on ESG Risk Management

The European Banking Authority (EBA) is tasked with issuing guidelines on **minimum standards** for the identification, measurement, management and monitoring of Environmental, Social, and Governance (ESG) risks by financial institutions. The guidelines aim to enhance institutions' resilience by setting requirements for internal processes and ESG risk management arrangements. Institutions are expected to c**onduct regular materiality assessments, employ sound data processes and utilize various methodologies to identify and measure ESG risks**. Integrating ESG risks into the overall risk management framework, institutions are required to develop robust approaches for managing and mitigating ESG risks over short, medium and long-term horizons. The guidelines also emphasize the importance of monitoring ESG risks through effective reporting frameworks and the development of prudential plans, aligning with regulatory objectives related to ESG factors. The **draft guidelines** are currently open for **public consultation**, with finalization expected by the **end of 2024**, pending the application date of CRD6.

Background and rationale of the Guideline on Managing ESG Risks:

In response to these challenges, EBA has formulated guidelines outlined in the **Capital Requirements Directive** (CRD) and **Capital Requirements Regulation** (CRR), underscoring the role of the financial sector in facilitating the transition to a sustainable economy while effectively managing associated financial risks. EBA underscores the necessity for institutions to systematically identify, measure and manage ESG risks to ensure resilience during the ongoing shift toward a more sustainable economy. The guidelines outline a legal mandate and objectives, including provisions for evaluating and overseeing institutions' strategies, policies, processes and systems related to ESG risks.

Additionally, EBA is empowered to issue guidelines specifying minimum standards and methodologies for ESG risk management. **Proportionality** is a central consideration in the guidelines, acknowledging that smaller institutions may also be exposed to ESG risks. Institutions are encouraged to implement proportionate strategies based on materiality assessments. The guidelines also **highlight** the significance of considering both financial and environmental-social materiality when assessing and managing risks.

Methodology for the identification and measurement of ESG risks

The **consultation paper** emphasizes the necessity for financial institutions to conduct regular **materiality assessments** of ESG risks within their strategies and procedures. The materiality assessment should consider **short, medium and long-term time** horizons, encompassing both **qualitative** and **quantitative** elements. It highlights the importance of evaluating the impact of ESG risks on various risk categories and encourages a risk-based approach considering likelihood and severity. The guidelines outline the need for **data processes, including the implementation of sound systems for collecting and aggregating ESG-related data**. The methodology for identifying and measuring ESG risks involves exposure-based, portfolio-based and scenario-based approaches. Exposure-based methods assess the impact of ESG factors on counterparties, while portfolio-based methods focus on alignment with sustainability targets. Scenario-based analyses, particularly for climate-related risks, are recommended with a reference to IEA net-zero emissions scenarios for certain portfolios. Institutions are encouraged to disclose outcomes of these assessments as part of Pillar 3 disclosures.

ESG Risk Management in Financial Institutions

It emphasizes the integration of ESG risks into the institution-wide risk management framework, advising on **risk identification, measurement, and mitigation** across traditional financial categories. Institutions are encouraged to embed ESG risks in business and risk strategies, incorporating insights from portfolio alignment methodologies and stress tests. Clear risk appetite definition, internal culture alignment, and three lines of defense model integration are highlighted. The guidelines stress the incorporation of ESG risks into Internal **Capital Adequacy Assessment and Liquidity Assessment**, including the evaluation of solvency and liquidity impacts. Specific attention is given to credit risk policies, market, liquidity, funding, operational, reputational, and concentration risks, with a focus on understanding and monitoring ESG impacts. The document concludes by underscoring the importance of effective monitoring **through internal reporting frameworks**, **early warning indicators**, and a range of metrics, seeking feedback on these guidelines for **ESG risk management.**

Plans in accordance with Article 76(2) of Directive 36/2013

The guidelines set out key principles for plans in **accordance with Article 76(2) of Directive 36/2013**. These include a materiality assessment basis for ESG risks, with a focus on environmental risks, particularly climate-related ones. Institutions are required to establish short, medium, and long-term horizons and milestones, ensuring consistency with other processes and communications. Governance involves clear roles and responsibilities, with the management body overseeing plan approval and implementation. Metrics and targets cover financed emissions, portfolio alignment and engagement with counterparties. Climate and environmental scenarios must align with legal and regulatory objectives and institutions should detail their transition planning processes.

The **main** aspects of the EBA’s guidance **consultation** are:

- Scope of the ESG risks guidelines
- Frequency of the materiality assessment of ESG risks

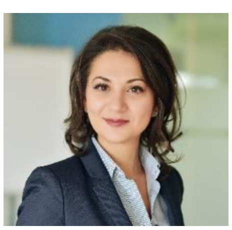
- Consideration of ESG risks in banks' business and strategies
- Data processes
- Features of reference methodologies for the identification and measurement of ESG risks
- Materiality assessment and (transition) plans
- Data and engagement with counterparties in relation to their transition plans
- Time horizons considered for banks' (transition) plans
- Plans' targets

Conclusion

In summary, EBA has proposed comprehensive guidelines for financial institutions to manage ESG risks. These guidelines stress regular assessments, robust **risk management approaches and integration into overall frameworks**. They recognize proportionality for smaller institutions and emphasize flexibility in methodology development. The guidelines also outline **key principles for ESG risk management plans.** Seeking public input, the EBA aims to enhance institutions' resilience in transitioning to a sustainable economy, aligning with regulatory objectives. The draft **guidelines are open for consultation** until the **end of 2024**.

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

Dimitrios Goranitis
Deloitte Global leader FSI Risk and Regulatory
Central Europe FSI leader
Tel: +40 751 250 884
Email: **digoranitis@deloittece.com**



Irina Vasile
FSI Risk & Regulatory Advisory
Senior Manager, Deloitte Central Europe
Tel: +40 730 585 755
Email: **irvasile@deloittece.com**

Source: https://www.eba.europa.eu/publications-and-media/press-releases/eba-consults-guidelines-management-esg-risks